1996

ANNUAL

MANAGEMENT

REPORT

OFFICE OF HOUSING - FEDERAL HOUSING ADMINISTRATION

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

The Federal Housing Administration 1996 Annual Management Report

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A Message from the Commissioner's Office

I am pleased that in Fiscal Year 1996 the Federal Housing Administration (FHA) has, *for the fourth consecutive* year, shown continued financial improvement **-** evidence of improved management, gains in efficiency, and streamlined operations.

FHA's achievements of this past year are numerous. For the second year in a row, the Mutual Mortgage Insurance Fund, which backs most single family mortgages, has exceeded the capital ratio Congress mandated for the year 2000. Annual claims on single family loans also fell 7 percent from the last fiscal year. Single Family's operations are being successfully consolidated and streamlined to improve customer service, increase productivity and reduce costs. Homeownership is at its highest rate in over a decade, with FHA contributing to this increase by insuring nearly 800,000 loans.

Recognizing that without acting proactively the cost of renewing Section 8 rental assistance contracts would increase from $1 billion in Fiscal Year 1997 to almost $4.5 billion in Fiscal Year 2002, FHA developed and proposed a plan to reengineer that portfolio. The plan restructures the multifamily portfolio so that a property's debt can be supported by market rents. This plan will end over-subsidization of properties, promote resident responsibility and choice in housing, and bring marketplace competition and incentive.

During 1996, FHA continued to recognize the value of joining with competent, willing partners who play critical roles in fostering homeownership, rental and health care facility opportunities. Fiscal Year 1996 also brought new partnerships focusing on increasing the rate of homeownership among African Americans and Latinos. FHA paired with the Congress of National Black Churches and the Council of LaRaza in multilingual and multicultural initiatives offering homebuyer education and counseling as well as outreach programs.

Looking forward to a paperless future and recognizing the power of electronic technology in achieving our goals, in 1996 FHA expanded its use of Electronic Data Interchange and the Internet to improve the quality of service to our customers.

As we face the future, I am encouraged by FHA's successes this year. They give me confidence that FHA will continue to reinvent itself aggressively and become even more streamlined, market driven, customer focused, and effective in furthering the Nation's housing goals.

Ira Peppercorn
General Deputy Assistant Secretary for Housing

I. The Federal Housing Administration

had lost their jobs and homebuyers seeking credit could only get loans up to fifty percent of value, for terms no longer than five years. With the National Housing Act of 1934, Congress established the Federal Housing Administration (FHA), a wholly-owned government corporation, to stabilize the mortgage market and to provide an adequate home financing system through insurance of mortgages. FHA was also charged in that legislation with the task of improving housing standards and conditions.

Over the course of the past six decades, FHA has been a persistent force in stabilizing markets and providing homeownership to those who would not otherwise have the opportunity. In the forties, FHA programs helped to finance military housing and then homes for returning veterans and their families. In the fifties and through the seventies, FHA stimulated production of millions of units of privately-owned apartments for elderly, disabled, and lower income Americans. When soaring inflation and energy costs of the seventies threatened the economic viability of thousands of private apartment buildings, FHA's emergency financing kept cash-strapped properties afloat. When a deep recession prompted private mortgage insurers to pull out of oil producing states in the eighties, FHA stepped in to stabilize falling home prices and ensure that purchasers could find financing for homes they wanted to buy.

FHA has been extremely successful in achieving its mission of supporting the availability of capital for single family homeownership and for the development of affordable rental housing. By 1996, FHA had provided homeownership opportunities for nearly 25 million families and has provided about 1.3 million privately owned HUD-assisted apartment units for 2.2 million people.

FHA continues to fill a critical niche in the market place by providing homeownership opportunities for first-time homebuyers, minorities and low- and moderate-income buyers who would go unserved by private insurers. In 1996, roughly 75 percent of our new business was insuring mortgages for people buying their first home, and 31 percent of these first-time home purchases were made by minority households.

The Mission

In 1934, the housing industry was stagnant, an aftermath of the great depression. Two million construction workers insurance. Simply put, over half a million families in that year would have been denied their chance at the American dream were it not for the presence and influence of FHA.

During Fiscal Year 1996, FHA continued to build on its success by insuring mortgages with unpaid principal balances totaling more than $71 billion, an increase of over 36 percent from the previous year. Insurance-in-force reached a level of $426 billion, and homeownership is at its highest rate in more than a decade.

FHA is being affected by rapid changes in the market place and in technology. It is increasingly challenged to do more with less as Federal downsizing occurs and funds for programs continue to decrease. The organization is aggressively reinventing itself to meet these challenges, evolving from a bureaucracy into a business driven institution. FHA is focused on meeting the challenges of the future while enhancing customer service and satisfaction, all within a framework that is fiscally sound, streamlined, and market driven.

FHA Today

A 1996 Report from the General Accounting Office (GAO) indicated that about 66 percent of the loans insured by FHA in 1995 would probably *not* have qualified for private mortgage

II. The Strategic Positioning of FHA

business practices, and to restore public trust in the agency. This Management Reform Plan focuses on six major reforms:

Reform One - Reorganize by function rather than strictly by program "cylinders." Consolidate and privatize where needed.

Reform Two - Modernize and integrate HUD's outdated financial management systems with an efficient, state-of-the-art system.

Reform Three - Create an Enforcement Authority with one objective - to restore public trust.

Reform Four - Refocus and retrain HUD's workforce to carry out our revitalized mission.

Reform Five - Establish new performance-based systems for HUD programs, operations, and employees.

Reform Six - Replace HUD's top-down bureaucracy with a new customer-friendly structure.

Operationally, FHA has been refining and adapting its processes in recent years based on certain principles, which facilitate and lend support to the Secretary's broader reforms. Financially, FHA has begun to see appreciable gains in productivity and fiscal soundness – gains that are directly related to having employed these key principles:

Managing the Portfolio Proactively

Providing Innovative Products and Services

Harnessing the Power of Technology

Establishing Public & Private Partnerships

Streamlining Operations

Plans will certainly evolve as legislative and market environments continue to change, but these principles will serve as the basis for conducting the business of FHA.

With his HUD 2020 Management Reform Plan, Secretary Cuomo introduced a broad plan that will reorient HUD to serve America's people and communities with improved

Managing the Portfolio Proactively

In Fiscal Year 1996, FHA's staff managed an insurance portfolio of $426 billion. Effective management of this portfolio and competent administration of the programs are critical to FHA's continued financial viability. These responsibilities pose a distinct challenge to FHA in an environment of dwindling resources.

Market fluctuations and changes in economic conditions will affect portfolio performance. FHA must have the tools and strategies in place to react quickly and adeptly to these conditions, minimizing their negative impact on portfolio performance. Over the past several years, FHA has become a more results-oriented, financially accountable operation. Processes have been put in place that have enhanced performance and enabled proactive management of the portfolio.

Proactive Single Family Portfolio Management

FHA has made great strides in management of its single family insurance portfolio with the introduction of a Single Family Loss Mitigation program which emphasizes early intervention in single family delinquencies. Under this program, FHA developed a menu of default avoidance and loss mitigation tools that provide alternatives to lenders in curing defaults and reducing losses, including: forbearance, loan modification, partial claims, deed-in-lieu, and preforeclosure sales. Lenders are provided incentives to use the tools, and measured on portfolio performance. This approach provides greater flexibility to lenders in managing defaults, more alternatives for assisting borrowers, improves overall portfolio performance, and reduces FHA workload.

During Fiscal Year 1996, this Loss Mitigation Program replaced the Single Family mortgage assignment program. Previously, single family mortgages had been assigned to FHA in a claims process, imposing a cost of staff time and resources to service these defaulted loans. When defaulted loans proceed to foreclosure, additional costs and losses are incurred. FHA is now positioned to realize cost savings in management of its single family portfolio.

During the late 1980s, FHA acquired a large number of mortgages due to the decline in real estate markets. In the early 1990s FHA owned almost 2,400 multifamily mortgages, with an outstanding balance of more than $7 billion, and over 100,000 single family mortgages with an outstanding balance of about $4 billion. This substantial inventory of HUD-held mortgages was costing taxpayers hundreds of millions of dollars annually, and compromising FHA's ability to perform its other principal functions, specifically production of new, affordable housing and effective management of the existing insured portfolio.

Beginning in Fiscal Year 1994, FHA instituted a note sales program to offload the burdensome and expensive assets. In Fiscal Year 1996, FHA sold 46,144 single family notes, 493 multifamily notes (including one Title X note) and 15,157 Title I notes. Combined note sales have generated taxpayer savings of more than $853 million and returned assets with an unpaid principal balance of $4.6 billion to the private sector for the year.

The asset sales program has benefited FHA in other important ways. It has increased FHA’s understanding of portfolio composition and performance, assisted FHA managers in refining portfolio strategies, and freed up FHA staff to focus on managing the insured portfolio to prevent defaults.

Proactive Multifamily Asset Management

While the majority of FHA's Multifamily properties are well maintained and problem free, there are a number of troubled or potentially troubled projects that need special attention. Multifamily Asset Managers have identified most of these projects, placing them under curative plans and monitoring the execution of the plans.

In Fiscal Year 1995 and continuing in Fiscal Year 1996, FHA established a Special Workout Assistance Team (SWAT) to focus on these types of projects and provide assistance needed to bring these properties up to standard. Owners and property managers generally comply with the curative measures recommended by the team. If they do not comply, sanctions are imposed. During Fiscal Year 1996, Multifamily reduced its inventory of troubled projects by 777. Multifamily's goal is to remove every troubled project from its insured portfolio by the year 2000.

Single Family and Multifamily Asset Sales

By awarding legal enforcement contracts, FHA has increased its enforcement capacity to act on recommendations made by SWAT teams regarding negligent owners. These contracts provide additional capacity and expertise to FHA and the Office of General Counsel, leveraging resources and decreasing the time required to exercise enforcement authority. Additionally, HUD has teamed with other Federal agencies such as the Department of Justice to put uncooperative owners and management agents on notice that consequences of their actions will have serious financial and punitive consequences.

As directed in HUD 2020, asset management and enforcement functions in the Offices of Housing and Public and Indian Housing (PIH) are being consolidated. All multifamily properties will be physically inspected and financially audited by outside contractors using a comprehensive and uniform protocol. The new agency-wide Enforcement Authority will be empowered to take action against properties that fail physical or financial audits, and owners who evade their responsibilities or engage in fraudulent activity.

General Risk Management

FHA recognizes that effective portfolio management is key to realizing its mission. The loans in the FHA portfolio have a variety of characteristics that affect performance, including geographic location, product type, property type, borrower characteristics, and loan type. Likewise, the portfolio’s performance can affect certain neighborhoods and communities quite dramatically, or vice versa. FHA seeks to balance and manage this broad spectrum of factors to optimize overall portfolio performance relative to the objectives of the organization. New computer software is being used for portfolio analysis. Computerized data warehouses are being built, and computer mapping technology employed to facilitate the staff’s understanding of portfolios, and to equip them to manage assets and risks prudently.

Providing Innovative Products And Services

The top-down organizational structure is necessarily giving way to feedback and communication structures. FHA, along with the other program areas in HUD, is focused on a reorientation to customer service. The staff has fully embraced this concept and continues to create mechanisms that allow for input from and direct response to its client base.

Feedback and Accessibility

As with any business, consulting the client is basic to determining how best to serve the client. In Fiscal Year 1995, FHA embarked on an ambitious effort to reach out to as many of its customers as possible. Maintaining this effort into Fiscal Year 1996, FHA began to conduct market surveys and to host sessions with stakeholder focus groups throughout the country. Based on findings from this research, FHA is refining or developing products and services that specifically meet the housing needs of underserved populations while maintaining the soundness of the portfolios.

New Product Development

FHA's response to focus group findings and industry input is the creation of new products that better reach underserved markets, address the needs of changing markets and seize opportunities in emerging market niches. These products are geared toward housing market segments that simply do not have adequate access to capital, including older or smaller properties, and those located in less attractive geographic markets. The products will serve neighborhoods and communities and reaffirm FHA's leadership role in serving this market.

Recognizing the value of homeownership, Single Family has reduced the mortgage insurance premium for first-time homebuyers who complete homebuyer education. This recently implemented program is expected to be effective in expanding homeownership rates and in reducing defaults.

The transition from bureaucracy to business is a refinement of FHA's mission.

underwriting systems to make the origination process more efficient and less costly, and to better manage risk. A pilot was begun with one GSE in Fiscal Year 1996.

The Multifamily risk sharing program has been successful in attracting quality partnerships, defining clear roles and responsibilities, sharing expertise and obtaining good results.

FHA insurance for health care facilities is an integral contribution to the economic development of communities. A new hospital risk-sharing program would expand available capital financing for the health care facility industry.

Education and Outreach

FHA has introduced a number of programs to engage its unserved but potential customers. Outreach is an underlying strategy in all of the programs designed to promote and facilitate homeownership. Single Family's Marketing and Outreach Division is establishing partnerships with communities, local governments, non-profits and private institutions to serve a goal of increasing U.S. homeownership rates to 67.5% by the end of the year 2000. In this partnership program, the mission and primary objective is to provide maximum homeownership options for the segments of the market that have traditionally been unserved or underserved by the private market. This is achieved by marketing FHA-insured mortgage products to potential homeowners, with the aid and support of local partners.

FHA is working with Government Sponsored Enterprises (GSEs) and private mortgage insurers (PMIs) to explore the use of automated

In Fiscal Year 1996, FHA initiated the Homebuyer Education and Learning Program (HELP) to advance the knowledge base of prospective homeowners in completing the home buying process. The HELP program is designed to provide detailed information on such topics as budgeting for a down payment and staying current on mortgage payments. The program also advises on locating, negotiating and purchasing, financing and maintaining the home. HELP is a national program in partnership with other interested groups, such as counseling agencies, local universities, community colleges and non-profit organizations.

The Neighborhood Networks initiative establishes computer learning centers in assisted and/or insured multifamily projects. The centers are designed, implemented, and operated by owners and tenants, with technical assistance from FHA. The centers provide access to information, education, and new skills for the residents and the community and contribute to the health of the FHA portfolio by enhancing the value of FHA insured properties. In addition, the centers provide an opportunity to facilitate the Administration's goal of moving people from welfare to work. In Fiscal Year 1996, 58 centers were made operational.

Linkage and Leverage with other HUD and Federal Programs

An underlying theme in the administration of FHA programs is leveraging other HUD and Federal investments. All of FHA’s products are designed to build better communities and improve the overall quality of life for people who reside in those communities. Geographically tracking FHA’s investments in a community is prudent and sound policy, allowing subsidies and community investments both to complement and be complemented by other federal spending. To this end, FHA will be able to draw on Community 2020, HUD’s award-winning mapping software, which provides a visual display tracking HUD funding to almost any community in the country. FHA information is contributed to this effort through its data warehouses. Information will be accessible to the general public, as software or over the Internet.

Harnessing the Power of Technology

Faced with shrinking resources, a greater workload, and a rapidly changing market, FHA is increasingly challenged to work smarter to keep current with workload demands and improve customer service. FHA views the use of technology as a powerful tool in achieving its goal of becoming a more efficient, performance-based entity. These efforts fully support President Clinton's National Performance Review (NPR) objectives, which encourage the development and implementation of strategies to make the Federal government more efficient, more responsive to customers, and less costly to taxpayers. This is the philosophy detailed by the Secretary in the HUD Management 2020 Report.

Internal System Integration

A longstanding goal for FHA is the improvement of financial management and information systems. FHA began an evaluation of its internal systems in 1994. Each program area developed an Information Strategy Plan (ISP) which was to provide a framework for systems development and enhancement in support of FHA business needs. The evaluation looked at the information, systems and technology in place, and inventoried the pressing strategic needs of the business units. The ISPs focus on the most critical business needs - those that reduce risk and better protect FHA's portfolio - then prioritize the system team’s efforts to address those needs in a phased implementation.

During Fiscal Year 1996, the plans served as an itinerary and road map for ongoing development of a capacity to access, analyze, and disseminate accurate and meaningful portfolio information. These ISPs are now being integrated into HUD’s Financial Systems Integration (FSI) plan for all of the agency’s financial management systems.

Analysis and Planning

FHA has a massive archive of information at its disposal in its various financial management systems. Through integration of the various databases maintained, FHA is creating data warehouses to allow ready access to key information about the multifamily and single family portfolios. Data warehouses extract financial and management information from mainframe transaction processing systems and store the data in a user-accessible database. The process requires an assessment and "scrub" of data sources, thereby enhancing the integrity of archived data. The Multifamily Data Warehouse was piloted in Field Offices in Fiscal Year 1996, with full implementation begun during Fiscal Year 1996.

The information can serve as the foundation for modeling and projecting portfolio behavior. The following initiatives were either put in place or expanded in 1996 to draw on the resource of internal data:

- Multifamily Risk Assessment Management System (RAMS), an early warning system which informs and supports loss mitigation efforts in the multifamily portfolio
- Continued risk ranking of the Multifamily portfolio which considers financial and operational factors at the project level and serves as the basis for the Multifamily loan loss reserve.
- The actuarial review of the MMI Fund, a continued evaluation of portfolio performance and projections of the fund through the Year 2000.
- Development of a microsimulation model for the MMI fund that will allow for sophisticated analysis of the overall impact of economic, market, portfolio and program changes on the MMI Fund.

Access to these stores of information will permit FHA staff to better evaluate and understand the portfolios, facilitating risk management, and moving the organization along the path from a bureaucracy to a business.

Electronic Commerce

One of the key components of achieving efficiency and reducing costs and the movement toward a paperless environment. The electronic exchange of information allows for more efficient interactions and reduces the costs of doing business. Early in Fiscal Year 1994, FHA began to move toward the use of electronic commerce as a means of conducting business. The use of Electronic Data Interchange (EDI) in lieu of paper processing results in fewer errors, reduces staff time, and enhances data quality.

The first EDI application to be implemented was the payment of Single Family claims. FHA has since moved aggressively to convert the following key processes to EDI:

- Insured loan status information allowing lenders to submit information electronically such as mortgage loan default status reports, mortgage change records, refund processing, and terminations of mortgage insurance.

planned for 1997.
Development of the Single
Family Data Warehouse was

- The Single Family Up-Front Premiums System was developed to streamline the premium payment process and provide improved internal controls, with full implementation in Fiscal Year 1997, with an EDI payment option known as EDI Bank.

The FHA Connection, an interactive Internet-based application that provides real-time access to FHA systems to originate loans, has been developed to provide a more immediate response to lender requests at a minimal cost.

FHA is exploring the utilization of Automated Underwriting. This research is to evaluate how this technology can be used to expand homeownership opportunities by making FHA-insured loans more affordable and easier to originate. In addition, FHA will seek to determine how automated underwriting can be used to identify credit-worthy borrowers that may have been excluded from homeownership under current underwriting guidelines.

Information Management and Institutional Archives

Besides facilitating administration and processing, technology has enhanced FHA's ability to communicate a variety of information to its business partners and the general public.

Information is now available to customers within moments or hours instead of days. Increasingly FHA is leveraging the Internet to streamline its business processes, as noted above. The HUD Intranet will also be used to improve internal communication and enhance productivity. The Intranet allows for seamless communication and accessibility for the field offices, crucial in the overall restructuring and streamlining of HUD. FHA plans to build on these efforts and fully utilize the Internet and Intranet as it moves toward its goal of operating in a paperless environment and enhancing the quality of services to its customers.

Year 2000

HUD systems were evaluated beginning in Fiscal Year 1996 to determine the level of effort required to make them Year 2000 compliant. Though some development began in Fiscal Year 1996, the majority will be done in Fiscal Years 1997 and 1998, and all systems are scheduled for completion by the beginning of the second quarter of Fiscal Year 1999.

Year 2000 renovations include upgrades to several platforms and operating systems which necessitate additional modifications to "retro-fit" into the new hardware/software environments. These upgrades will be completed in Fiscal Year 1998.

Establishing Public & Private Partnerships

constituencies.   A key component of FHA's strategy for future operations is to continue this engagement of constituencies. FHA recognizes that there are a number of competent and willing partners who have the ability to play a critical role in leveraging limited Federal resources.

Facilitating Outreach and Education

While homeownership is on the rise after many years of decline, this increase is occurring primarily in suburban areas leaving certain segments of the population behind to live in decaying urban areas. Between 1991 and 1993, the number of people living in substandard housing grew by 400,000, to a total of more than 5.3 million. Increasingly, families are forced to pay more than half of their income for rent. With such a large unserved market and in a period of declining Federal resources, FHA recognizes that the only effective way to provide the level of services needed is to reach out and establish effective partnerships and alliances.

FHA set as a goal for 1997 a 2% increase in the percentage of first-time homebuyers over the Fiscal Year 1995 levels with continued increases through 1999. During Fiscal Year 1996, FHA established working relationships with several community partners who will prove essential to that goal.

Partnerships for Minority Outreach

There is consensus that minority outreach is crucial in realizing these homeownership goals. FHA has established a new partnership with the Congress of National Black Churches that is designed to increase the rate of homeownership among African-Americans through homebuyer education classes and counseling programs at black churches around the country. Under the new partnership, called Home-Now, a number of black churches in several cities will host education sessions on the home-buying process, as well as offer homebuyer counseling and other programs specifically tailored to meet the needs of first-time African-American homebuyers.

In the process of soliciting input from stakeholders, FHA established a number of working partnerships with

Council of LaRaza designed to increase the rate of homeownership among Latinos through homebuyer education classes and counseling programs in designated areas around the country. The Council of LaRaza, through affiliated Latino community-based organizations, will provide home buyer education and counseling to individuals and families in order to prepare them to become home owners.

Community Partnerships

The Neighborhood Networks program, noted previously, establishes computer learning centers in assisted and/or insured multifamily projects and is designed to help move residents from welfare to work. These centers are supported by a combination of local businesses, colleges and universities, local governments and project owners. The centers provide opportunities for residents to receive job/career training, continuing education, employment assistance and social and medical services. An agreement has been reached between the Department of Labor and HUD, which will enhance the residents' chances of finding meaningful work.

During Fiscal Year 1995, The Safe Neighborhood Action Plan (SNAP) initiative was launched. This initiative partners FHA with the U.S. Conference of Mayors and the National Assisted Housing Management Association to address crime, safety and other quality of life issues. This initiative continued in Fiscal Year 1996, with an expansion scheduled for 1997. It has proven to be extremely effective in reducing crime as measured by the number of recorded police calls.

Major progress has been made in partnering with local government entities and private sector businesses. These entities have taken on a number of Multifamily Housing's development activities including appraisals, mortgage credit, and underwriting for FHA insurance. This will enable the streamlined FHA to focus on oversight and monitoring of partners. An example of these partnerships in action is risk sharing - in which state housing finance agencies are responsible for underwriting activities and share risk with FHA. Another example is the implementation of a "Fast Track" initiative, which allows lenders to contract for underwriting services.

FHA has also established a new partnership with the

Risk-Sharing Partnerships

FHA has established risk-sharing relationships with dozens of state housing finance agencies for financing and development of multifamily properties. To date, risk-sharing is in place to add units to the affordable housing stock. A risk-sharing program is currently under development for health care facilities and single family.

Health Care Partnerships

Much of the FHA-insured hospital portfolio is located in the state of New York, so FHA has aggressively pursued a stronger working relationship with the state. Areas of cooperation include information sharing, joint monitoring of FHA-insured institutions, and establishment of various state funds to help FHA hospitals make the transition to a deregulated and market-driven system. FHA formed an agreement with the Dormitory Authority of the State of New York to enhance the coordination and oversight of the New York State hospital portfolio.

Internal Partnerships

The HUD 2020 plan consolidates many management and oversight functions across the agency, creating both cost savings and operational efficiencies. As noted elsewhere, these joint administration functions include asset management, enforcement, and Section 8 contract reviews and renewals.

Streamlining Operations

The principle of streamlining operations cuts across the other four principles guiding FHA operations. In the creation of new products and services, FHA is updating processes and eliminating redundancy or obsolescent modes of conducting business. With the engagement of partners to serve FHA's constituencies, the organization is leveraging external expertise and infrastructures that reach into communities. Harnessing technology provides the means for more sophisticated management of the portfolio with fewer resources. It also serves as a mechanism for communication, administration, and the provision of services. Each of the other principles has operational efficiency - streamlining - at its foundation.

Over the next several years, FHA will be undergoing significant downsizing to conform with Congressional requirements to reduce the size of the Federal Government. With the dual pressures of an Executive mandate to downsize and the responsibility to manage large workload volumes, FHA is forced to make operational adaptations that enhance efficiency.

FHA is aggressively examining every facet of its operation to weed out inefficiency and establish an operation that is lean and highly skilled to meet the challenges of operating effectively in the future. Reengineering of both the organization and the processes are bringing about measurable gains in operational efficiency. The organization is focusing creative energies on ways to increase productivity with less staff while simultaneously improving customer service and satisfaction.

Processes and Organizational Structure

The Secretary's "Management 2020" plan calls for a new focus on reorganizing by function, not program, and consolidating operations to gain economies of scale.

As part of the general Office of Housing reorganization, Single Family initiated a consolidation and streamlining plan to improve customer service, increase productivity, and reduce cost. Fiscal Year 1996 saw Single Family field office operations continue to consolidate from eighty locations into four "Homeownership Centers," specialized and highly productive back offices. The first Homeownership Center was established in Denver in 1995.

Many of Multifamily's operations will also be consolidated in regional processing hubs. FHA has also delegated greater decision-making authority to field offices, improving resource flexibility and equalizing workload across staff. Multifamily also reengineered the underwriting and approval process by building on industry models and experience, and delegating contracting for appraisal and engineering services to the project sponsor. The result - Fast Track - reduced time to issue commitments in many offices, enabling field staff to focus on underwriting decisions rather than administrative process. Processing and payment of Section 8 vouchers is being consolidated from the field offices into one location. With continued downsizing and the need to monitor the insured portfolio more effectively, Multifamily will continue to pursue streamlining opportunities while delivering quality service to customers and minimizing the cost to the taxpayer.

Personnel

Business process reengineering, the impact of technology, and radical changes in the mortgage business have changed the functions that FHA staff need to perform, with a shift toward more complex, technical, and analytic responsibilities. The reorganization and reengineering will necessarily include a crucial multi-year staff training plan to facilitate this comprehensive strategy.

Two more Centers, Atlanta and Philadelphia, were introduced in 1996, with a fourth Center in Santa Ana scheduled to open in 1998.

III. Overview of Financial Operations

"FHA is changing for the better. We applaud management for its consistency in its efforts to make FHA relevant in, and responsive to, the marketplace. Although the process is challenging, the steady and diligent actions of past years are beginning to produce results."
Independent Auditor's Report of Fiscal Year 1996 Financial Statements

FHA's Improving Financial Health

FHA's financial health is improving. For the fourth consecutive year, an independent audit conducted for the Department's Office of the Inspector General indicated that the Federal Housing Administration's once-troubled insurance fund has continued to demonstrate financial improvement. This independent assessment reflected the progress FHA has made in addressing the agency's financial and management problems. It is likewise important to note that the auditors once again provided an unqualified opinion on FHA's financial statements attesting to their confidence that the statements present fairly FHA's results of operations, financial position, and cash flows.

Several indicators evidence FHA's improved financial health:

- FHA's Mutual Mortgage Insurance Fund, which backs single family mortgages, exceeded a Congressionally mandated capital ratio goal for the year 2000 for the second year in a row.
- FHA's successful loan sales program continued to reduce inventories of single family and multifamily notes.
- FHA's annual claims on single family loans continued to fall.

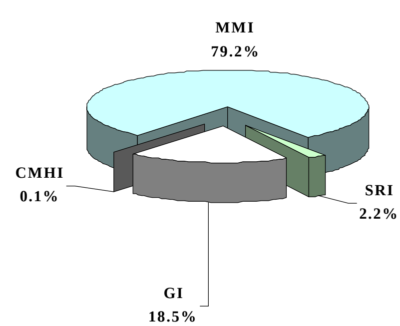
Following is a description of FHA's structure, highlights of the operational results for Fiscal Year 1996, and a discussion of the financial position of the insurance funds managed by FHA.

financing single family homes, multifamily projects, health care facilities, property improvements, and manufactured homes. The primary goal of FHA's insurance programs is to expand home ownership and affordable housing opportunities for all Americans. FHA's programs are financed through a Public Enterprise Revolving Fund, the FHA Fund, which is supported through premium income, investment income, Congressional appropriations, and other miscellaneous sources.

The FHA Fund is comprised of the following four sub-funds:

- The Mutual Mortgage Insurance (MMI) Fund, which supports FHA's basic single family home ownership program and historically has been self-sustaining.
- The General Insurance (GI) Fund, which supports a variety of multifamily and single family insured loan programs for rental apartments, cooperatives, condominiums, housing for the elderly, nursing homes, hospitals, property improvement and manufactured housing (Title I), and disaster assistance.
- The Special Risk Insurance (SRI) Fund, which supports multifamily rental properties and loans to high-risk borrowers, many of whom have in the past been eligible for subsidized interest rates.
- The Cooperative Management Housing Insurance (CMHI) Fund, which supports insurance on market-rate cooperative apartment projects and, like the MMI Fund, has historically been self-sustaining.

Composition of FHA Insurance-in-Force as of September 30, 1996



FHA insures private lenders against losses resulting from borrower default on mortgages

Results of Operations and Financial Position

While revenues increased in Fiscal Year 1996 by $40 million, FHA's expenses for the same period increased approximately $3 billion resulting in a net deficit in FHA's overall operations for the first time in four years. The $3 billion increase in expenses was due predominantly to changes in the multifamily loan loss reserves over the past two years. The Fiscal Year 1996 increase in loss reserves is primarily attributable to an expected increase in claims payments for mortgages on properties as Section 8 contracts expire and rent levels are reduced. This increase was partially offset by improved recoveries upon ultimate resolution of default claims.

Positive results from the loan sales have lead to the reduction of the provision for losses on the mortgage notes portfolio at September 30, 1996. FHA recognized note sales gains of $187 million in Fiscal Year 1996 and $531 million in Fiscal Year 1995, after considering the related loss allowance, unearned discount, and cost of sales.

FHA's overall deficit increased by approximately 17 percent in Fiscal Year 1996 due to a $618 million operating deficit and a net receipt of $60 million in appropriations. Although FHA's deficit increased, cash and investments increased $5.3 billion and mortgage notes held for sale net of allowance for loss was reduced by $2.1 billion, or 35 percent. The reduction in the mortgage notes portfolio will reduce future loss exposure and the costs of servicing these assets.

FHA Results of Operations
By Fiscal Year
(Dollars in Billions)

	1992	1993	1994	1995	1996
Revenues	2.589	2.642	2.818	3.150	3.190
Expenses	9.414	1.016	1.670	0.760	3.808
Net Income	(6.825)	1.626	1.148	2.390	(0.618)

FHA Statements of Financial Condition
as of September 30th
(Dollars in Billions)

	1992	1993	1994	1995	1996
Assets	14.1	14.8	15.8	17.3	20.5
Liabilities	22.8	21.1	21.3	20.6	24.3
Equity	(8.7)	(6.3)	(5.5)	(3.3)	(3.8)

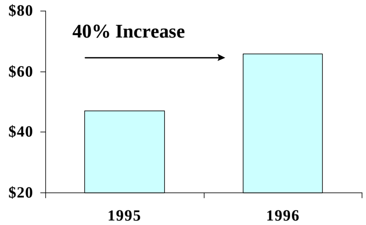
Insurance Written in Fiscal Year 1996

In Fiscal Year 1996, FHA insured mortgages with unpaid principal balances (UPBs) of over $71 billion, an increase of over 36 percent from the previous year. The increase is primarily due to growth in single family mortgage insurance. FHA insured nearly 800,000 single family loans totaling almost $66 billion. This dollar amount reflects a 40 percent increase over Fiscal Year 1995.

FHA also insured 465 multifamily mortgages with UPBs totaling $2.7 billion, 5 hospital mortgages with UPBs totaling $249 million, and 157 new nursing home mortgages with UPBs totaling $1.0 billion during Fiscal Year 1996. In addition, Title I lenders originated 107,392 property improvement loans for $1.6 billion, and 3,498 manufactured home loans for $101 million.

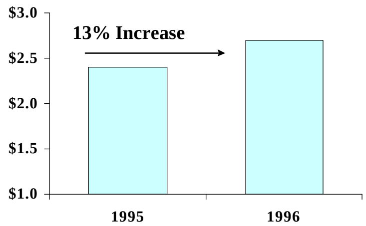
Single Family

$65.9 Billion - 788,789 Loans



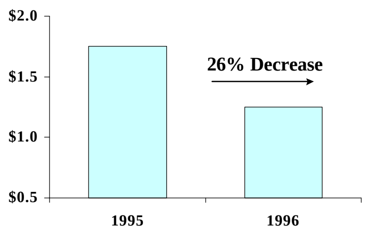
Multifamily

$2.7 Billion - 465 Loans



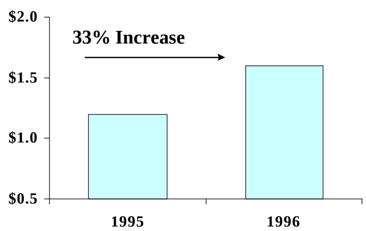
Hospitals & Nursing Homes

$1.25 Billion -162 Loans



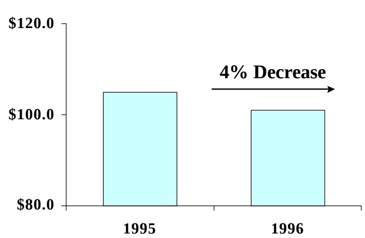
Property Improvement

$1.6 Billion - 107,392 Loans



Manufactured Homes

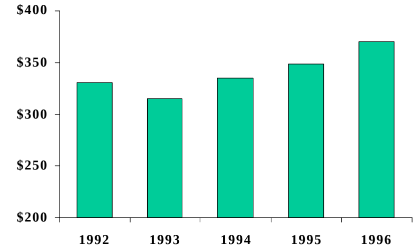
$101 Million - 3,498 Loans



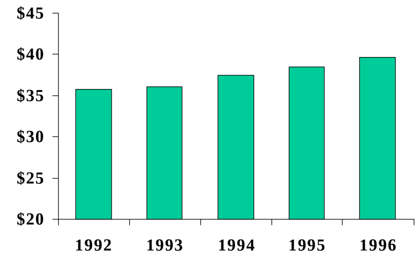
New Insurance

Insurance In Force
As of September 30, 1996

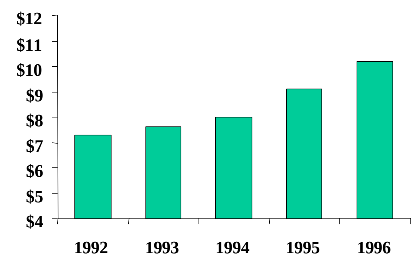
Single Family
$370.3 Billion



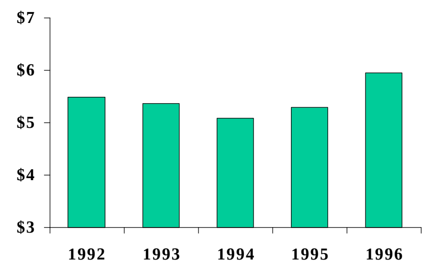
Multifamily
$39.6 Billion



Hospitals & Nursing Homes
$10.1 Billion

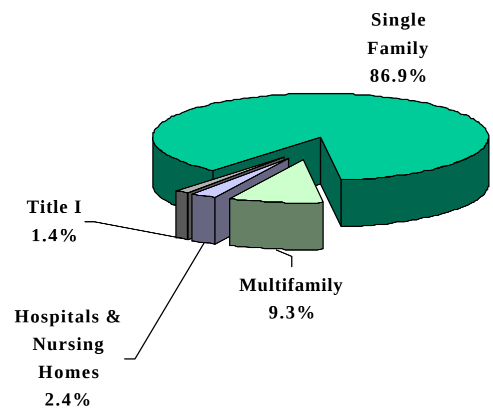


Title I
$6.0 Billion



Mortgage insurance-in-force grew to $426 billion, an increase of 6 percent over Fiscal Year 1995. This rise of approximately $23 billion was a result of an increase in the MMI Fund of $20 billion, a $4 billion increase in the GI Fund, offset by a decrease of $551 million in the SRI Fund. Single family mortgage insurance comprised 86.9 percent of the insurance-in-force; multifamily rental comprised 9.3 percent; hospitals and nursing homes, 2.4 percent; and Title I property improvement and manufactured home insurance comprised the remaining 1.4 percent.

Insurance in Force by Product Type
as of September 30, 1996



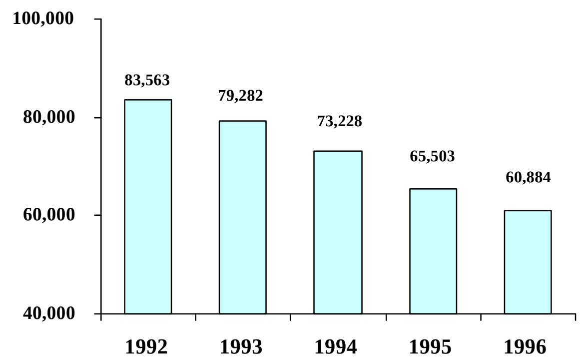
Claims

FHA paid approximately 60,900 single family insurance claims in Fiscal Year 1996, compared

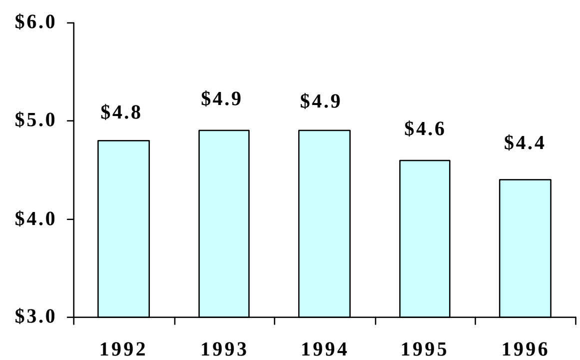
to 65,500 in Fiscal Year 1995, a 7 percent decrease. Since 1992, the number of single family insurance claims decreased by 27 percent. FHA's single family claim payments declined by $124 million or 3 percent from 1995 to $4.4 billion in 1996.

Other claims paid by the FHA in 1996 were: 94 multifamily insurance claim payments, totaling $230 million, a payment decline of 48 percent from the previous year; 4,527 property improvement insurance claims, totaling $51 million, a payment increase of 28 percent over 1995; and 1,866 manufactured home insurance claims of $17 million, a claims payment decline of 26 percent from 1995.

Single Family Claims Paid, FY 1992-1996



Single Family Claim Payments, FY 1992-1996
(Dollars in billions)

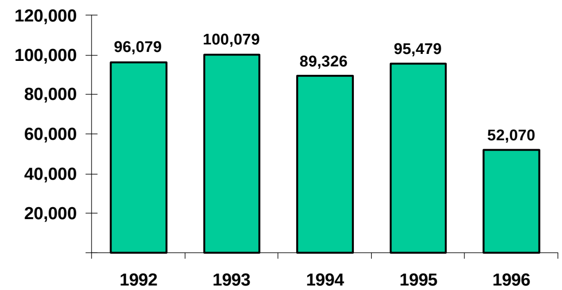


Secretary-Held Mortgage Notes

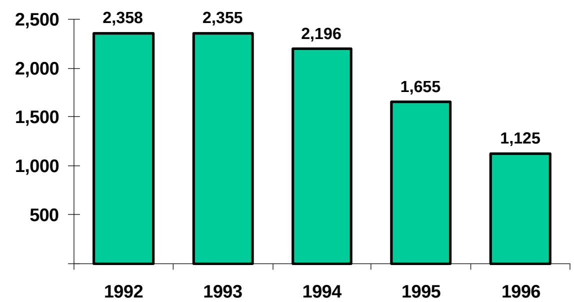
In prior years, FHA would take assignment of single family notes when defaults resulted from temporary hardship conditions. During Fiscal Year 1996, however, Congress mandated that FHA discontinue the single family assignment program and develop and implement a loss mitigation program to reduce defaults and related costs. It is anticipated that the UPB of Secretary-held mortgage notes will continue to decline as a result of ongoing notes sales and as the new single family loss mitigation initiatives are implemented.

The overall UPB of Secretary-held mortgage notes declined 41 percent between Fiscal Years 1995 and 1996 primarily due to the ten mortgage notes sales held during Fiscal Year 1996. The single family note inventory UPB decreased 37 percent (from $4.77 billion to $3.02 billion) and the total inventory decreased by 45 percent, from 95,479 notes to 52,070. The UPB of the multifamily note inventory declined 47 percent (from $5.69 billion to $3.02 billion), with the number of notes in inventory declining by 32 percent from 1,655 to 1,125. The Title I note inventory UPB decreased by 23 percent from $380 million to $294 million. The UPB of the health care (hospitals and nursing homes) note inventory increased slightly, 3 percent, from $230 million to $236 million.

Single Family Secretary-held Note Inventory as of September 30th

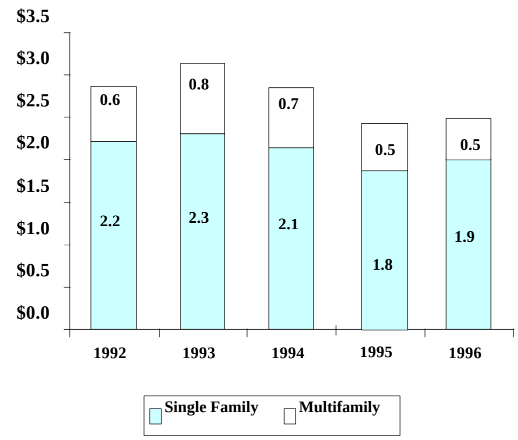


Multifamily Secretary-held Note Inventory as of September 30th

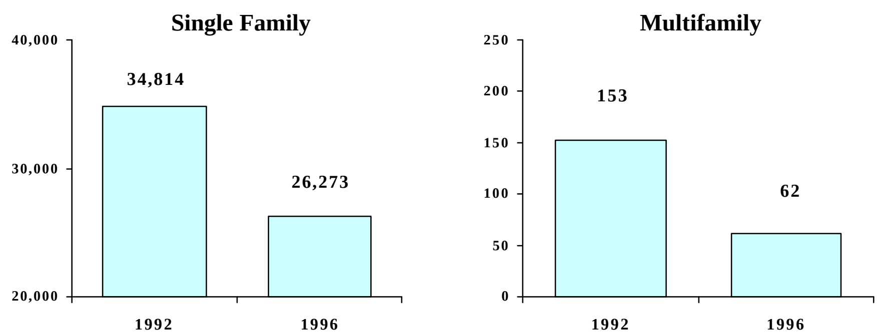


While there was a slight increase (3 percent) in the value of the foreclosed property inventory in Fiscal Year 1996, the inventory has declined by $783 million since 1993. Between Fiscal Years 1992 and 1996, the number of single family properties declined from 34,814 to 26,273, and multifamily properties declined from 153 to 62.

Secretary-owned Property Inventory
as of September 30th
(Dollars in billions)



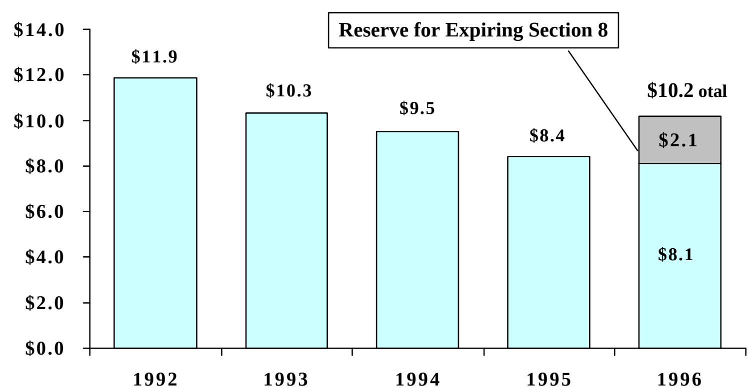
Secretary-owned Property Inventories
as of September 30th



that have occurred or that probably will occur among insured single family and multifamily mortgages and Title I loans. For Fiscal Year 1996, the single family loss reserves experienced a modest increase of $108 million (4 percent) to $2.6 billion, while the total insured portfolio grew by 6 percent. Title I loss reserves remained steady at $118 million.

During Fiscal Year 1996, FHA increased the multifamily loan loss reserve by $2.1 billion for the estimated impact on the multifamily portfolio of expiring Section 8 contracts. This is based on FHA's analysis of the financial impact of potential rent subsidy reductions on subsidized projects. As a result, the multifamily loan loss reserve increased to $10.2 billion. Excluding this additional reserve, the multifamily loan loss reserve continued to decline by $287 million despite a 4 percent growth in the insured portfolio.

Multifamily Loan Loss Reserves
as of September 30th
(Dollars in Billions)



Loan Loss Reserves

FHA maintains loan loss reserves for the estimated costs of future mortgage insurance claims resulting from defaults premiums reflects up-front single family premium collections of $1.4 billion, partially offset by premium refunds of $410 million and premium earnings of $768 million.

Borrowings

During Fiscal Year 1996, in compliance with Credit Reform requirements, FHA borrowed $1.6 billion from the U.S. Treasury primarily to cover net cash inflows from the termination of the assignment program and subsidy re-estimates. FHA repaid $140 million of prior year borrowings related to the GI and SRI Funds.

Appropriations

As required by statute, the MMI Fund must be able to have its insurance premiums cover its losses. However, GI and SRI insurance premiums are not sufficient to cover losses or to sustain the operations of their respective Funds. As a consequence, the GI and SRI Funds receive appropriations for positive credit subsidy. In Fiscal Years 1996 and 1995, appropriations for new insurance in the GI and SRI Funds were $152 million and $188 million, respectively. GI and SRI administrative expense appropriations for Fiscal Years 1996 and 1995 were $202 million and $198 million, respectively.

The MMI programs produced negative credit subsidy through new insurance ($1.5 billion in Fiscal Year 1996 and $869 million in Fiscal Year 1995). Administrative expenses for the MMI Fund are not covered by appropriations, but are funded by negative subsidies. In Fiscal Years 1996 and 1995, $342 million and $309 million were used for MMI administrative expense, respectively.

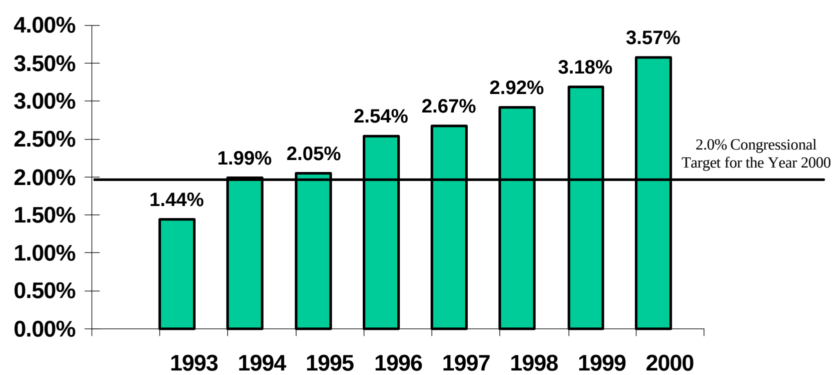
Unearned Premiums

The MMI Fund's single family insurance program accounts for $239 million of the $246 million net increase in the FHA's unearned premiums balance. This net increase in unearned

MMI Fund Capital Ratio

The Cranston-Gonzalez National Affordable Housing Act of 1990 requires an independent actuarial analysis of the economic net worth and soundness of the MMI Fund. The Act also mandates that the MMI Fund achieve a capital ratio (a measure of the Fund's cushion against unexpected insurance losses) of at least 2.00 percent by the year 2000. The cushion ensures that FHA's basic single family insurance program could withstand unexpected losses without exposing the taxpayers to financial risk. The MMI Fund's capital ratio was 2.05 percent at the end of Fiscal Year 1995, the first time it exceeded the 2.00 percent year 2000 requirement. For Fiscal Year 1996, as a result of the continued strengthening of the Fund, the capital ratio increased to 2.54 percent. The Fiscal Year 1996 actuarial study also projected that the capital ratio for the year 2000 will be 3.57 percent.

MMI Fund Actual and Projected Capital Ratios



IV. Management's Report On Internal Controls

KPMG Peat Marwick, identified three material weaknesses which are discussed in this section. In its Fiscal Year 1995 audit, KPMG Peat Marwick had reported a fourth material weakness, related to Secretary-held multifamily and single family mortgage notes. However, due to the phenomenal success achieved by FHA in selling its portfolio of assigned notes, this fourth material weakness has been downgraded to a reportable condition in the 1996 audit. While material weaknesses remain, FHA has made significant strides in addressing these deficiencies through a series of planned actions outlined in its Material Weaknesses Action Plan. The highlights of these achievements are presented below. Detailed descriptions of these actions can be found in the Independent Auditors Report at Appendix A.

FHA's progress is slow but steady in addressing deficiencies that will ultimately enable the elimination of these longstanding material weaknesses. Having one material weakness from FY 1995 downgraded to a reportable condition attests to this progress. While there are barriers that continue to impede progress, FHA made impressive inroads toward reinventing itself and rethinking how it does business, better engaging partners, and using technology more effectively to perform work and improve communications.

We will be building on this year's successes as we move business process reengineering to center stage. During Fiscal Year 1997, we plan to reexamine each business process to determine if we are operating in the most streamlined, efficient manner feasible. The organization will also assess whether or not certain functions can or should be eliminated. By constantly reinventing ourselves, seeking creative ways to effectively remove barriers and forge additional partnerships, FHA expects to accelerate its rate of progress in closing out these remaining weaknesses.

In its 1996 Report on Internal Controls, FHA's auditor,

Material Weakness

Number 1 - FHA should address staff and administrative resources issues.

Partnerships and contracting relationships have been established to leverage FHA staff resources. Portfolio management tasks are being offloaded to contractors, field offices and mortgagees. Technology has been introduced to facilitate time and staff efficiencies by delivering better portfolio information and analytical capacity to the FHA management team. The organization itself is being reengineered to realign staff resources with workload. The following are key actions taken to address staffing resource issues.

Multifamily

Systems. Completed a Business Area Analysis to identify the information and systems needed by Multifamily staff for more effective portfolio management. Developed an implementation plan consistent with budgetary requirements for phase-in of systems. Improved systems for tracking, targeting, monitoring and analyzing portfolio activity. Fully implemented the Multifamily Data Warehouse and provided training to Field Offices to promote efficient use. Phase I of the Risk Assessment Management System (RAMS) was developed and is expected to be fully implemented by the end of Fiscal Year 1997. Work was also initiated on Rapid Application Development of systems for application processing and physical inspections.

Contractor Support. Acquired contractor support for critical workload areas: 1) A legal enforcement contract was awarded in January 1996 to provide resources for taking action against negligent project owners; 2) A contract for providing specialized asset management is expected to be awarded which will provide Field Offices with consultant services in performing the more complex work involved in portfolio management; and 3) a contract for collecting annual financial statements of insured multifamily projects is expected to be awarded by the end of Fiscal Year 1997.

Mortgagee Support. Continued to work with mortgagees in using Electronic Data Interchange (EDI). Mortgagees began the electronic reporting of default, delinquency and reinstatement information which reduced data entry requirements of Multifamily staff. Additional mortgagees will be added to the system throughout Fiscal Year 1997.

Consolidation. Consolidated and equalized workload to leverage scarce resources. Property disposition was consolidated in the Fort Worth and Atlanta offices; voucher processing for 29 Field Offices was consolidated in the Kansas/Missouri State office. All voucher processing will be consolidated in the voucher processing hub by December 1997. Coinsurance activities are expected to be consolidated in Greensboro by April 1997.

Multifamily, cont.

FHA has engaged in a range of efforts to reengineer its operations wisely.

Overarching restructure. Initiated a reinvention and reengineering effort to consolidate all FHA hospital program activities under a new Office of Insured Health Care Facilities. Consolidation will address serious operational inefficiencies, delays and poor client services.

Single Family

Asset Sales. Completed the sale of 493 notes (including one Title X note).

Better Information. Initiated the development of the Single Family Data Warehouse in the fourth quarter of 1996. The Data Warehouse will provide a single source of information for analyzing and managing the Single Family portfolio. Development and implementation are scheduled to continue through 1997 and 1998.

Consolidation. Further consolidated Field Office servicing of assigned notes. Established two additional Homeownership Centers in Philadelphia and Atlanta. Remaining servicing will be consolidated in a single Homeownership Center by the end of Fiscal Year 1998. Completed a Business Process Reengineering study of the Asset Recovery Centers.

Asset Management and Sales. Implemented the loss mitigation program which replaced the assignment program. Completed the sale of 46,144 Single Family notes and 15,157 Title I notes.

Electronic Processing. Continued EDI initiatives. Expanded the number of mortgagees filing claims electronically. Expect to have all mortgagees file claims electronically by June of 1997.

Status of Efforts

FHA continued to make progress in addressing this material weakness through the multi-pronged strategy of business process reengineering, consolidation of functions, increasing the use of contractors, and entering into partnerships. FHA intends to continue this strategy by adding additional processing hubs by December of 1997 and adding an additional homeownership center in FY 1998. It is anticipated that through this combination of actions, FHA will be able to close this material weakness by the end of FY 1999.

Material Weakness Number 2 - FHA must place more emphasis on early warning and loss prevention for insured mortgages.

Key Actions Taken:

Multifamily

Systems for Evaluation and Analysis. Continued to focus on improving information systems to enhance Multifamily's ability to track, target, monitor and analyze the Multifamily portfolio. Business Area Analysis resulted in plans to develop a series of systems over time which will be integrated and fully support development and asset management activities. Systems developed and currently underway resulting from this effort are the Multifamily Data Warehouse, the Risk Assessment Management System, Community Wizard, and the Application Processing and Basic Physical Inspection systems

Engaged Contractors for Evaluation and Analysis. Awarded contracts and have others underway to procure contractor services to provide support in the critical workload areas of reviewing annual financial statements of multifamily projects, analyzing and performing complex work associated with portfolio management, and carrying out enforcement actions against project owners.

Section 8 Demonstration. Initiated a demonstration for restructuring insured projects using project based Section 8 to prevent or reduce claims upon the expiration of Section 8 contracts. The demonstration was to serve as a research mechanism to sample conditions surrounding contract expirations. The 1997 appropriations bill authorizes a demonstration program of 50,000 units. Additional authorization will be sought for FY 1998 and beyond to carry out this key initiative.

Contractors for Asset Management. Continued the use of Special Workout Assistance Teams (SWAT). To date, SWAT teams have reviewed 451 of the most troubled and potentially troubled projects. During FY 1997, Multifamily's goal is to place 477 troubled projects under compliance plans and to remove 414 projects from the inventory of troubled projects.

Multifamily, cont.

which are designed to improve neighborhoods and protect the Multifamily portfolio.

Single Family

Early Intervention By Mortgagees Initiated actions to transition from the mortgage assignment program to the new loss mitigation program. This program encourages the use of various tools by mortgagee as alternatives to foreclosure. It is estimated that approximately 50 percent of seriously delinquent loans will be cured through borrower self-help and that 45 percent will avoid foreclosure through the use of these tools.

Measuring Impact of Loss Mitigation. Initiated the development of a methodology to analyze loss mitigation tool usage, performance and effectiveness. A scoring system is under development which will provide Single Family with the information it needs to assess the effectiveness of the loss mitigation program. The system is scheduled to be implemented in Fiscal Year 1997.

Quality Assurance. Increased the Quality Assurance Division (QAD) staff for performing on-site reviews from approximately 30 to over 70. During Fiscal Year 1997, it is planned to add 25 QAD staff to each Homeownership Center in Philadelphia and Atlanta and to add 50 additional staff to QAD during fiscal year 1998.

Automated Underwriting Pilot. Initiated a pilot program to apply automated underwriting technology to FHA-insured loans, measure and manage risk of originations. A pilot program was offered to a limited number of mortgagees for a test period.

Increased Monitoring and Enforcement. Improved the Single Family Default Monitoring System (SFDMS). Single Family began to assess penalties against lenders who report inaccurate information and those who fail to report the default status of borrowers. To supplement this effort, more attention will be focused on this area by the post-claim review contractor and the QAD staff during on-site and post-claim reviews. Single Family also began using the SFDMS to identify servicers with excessive default rates and those that have below average "cure" rates for the mortgages they service so that they can be more closely monitored.

Protecting the Portfolio. Implemented Neighborhood Networks as part of Multifamily's “place based” development programs

Single Family, cont.

Analysis System (MPAS), which monitors mortgagee claim and default rates. If a mortgagee's default and claim rates are deemed excessive (greater than 150 percent of average rates), the mortgagee is placed on credit watch status and monitored closely for a period of at least six months. Plans are to terminate the approved status of mortgagees whose claim and default rates exceed 200 percent of the normal average rate for the area. Beginning in 1997, FHA will conduct a quarterly analysis of claim and default rates to identify below par lenders.

Tracking Financial Stability of Mortgagees. Initiated the development of a database to track and review financial stability of mortgagees. This system will be used to identify mortgagees experiencing financial difficulties and highlight negative financial trends as an early warning indicator for troubled mortgagees. Information will be used to assist in identifying mortgagees for on-site reviews. Single Family will begin inputting financial data to the system during 1997 and expect to have data for performing trend analysis by 1999.

Status of Efforts

FHA's success in obtaining contractor support to augment Multifamily staff was a key component in addressing this material weakness. For many years, Multifamily has recognized the need to better monitor its portfolio but has not had sufficient staff to do so. Having contractor support to perform the information management frees up Multifamily staff to concentrate more on the analysis and management of the portfolio. With the addition of contractor support and the progress made in developing systems which provide risk-ranking information, FHA will be equipped with the skills and tools it needs to more aggressively monitor the portfolio and take proactive steps to protect FHA's interests. Systems and program initiatives planned for Fiscal Year 1997 and beyond will further enhance FHA's capability in this area and hopefully will enable the closing of this material weakness by Fiscal Year 1998.

Tracking Operations of Mortgagees. Developed and implemented the Mortgage Portfolio

Material Weakness Number 3 - FHA must improve accounting and financial management systems.

Key Actions Taken:

Systems Planning and Implementation. Completed the Multifamily Business Area Analysis (BAA) and began development of an integrated Multifamily system. The BAA identified a series of systems which fully integrate the development and asset management functions of Multifamily and established an implementation plan for phasing in systems based on criticality of need. The Multifamily Data Warehouse and the Risk Assessment Management System are the first two systems to be developed as a result of this effort. Development is underway for an Applications Processing System and a Basic Physical Inspection System. Began development of the Single Family Data Warehouse. The warehouse pilot test for Phase I has already begun. The Project Plan, supporting activities, and budget authority for 1997 through 2000 has been developed and approved.

Integration of Systems. Moved three systems formerly run by contractors to the HUD platform to achieve systems integration. Systems implemented were the Single Family Acquired Asset Management System (SAMS), the Debt Collection and Management System (DCAMS), and the Home Equity Conversion Mortgage System (HECMS).

Integration of Accounting Systems. Developed a plan and timetable for enhancing the general ledger which is expected to be implemented by the end of Fiscal Year 1997. Plans are to have a fully integrated financial management system by the end of Fiscal Year 1998.

Systematic Credit Reform Management. Developed a plan for fully implementing the requirements of Credit Reform. Current systems have been enhanced to meet certain Credit Reform requirements. Remaining systems will be upgraded to fully comply with Credit Reform requirements during Fiscal Year 1998.

Systems to Facilitate Operations. Developed the Single Family Premium Collection System for up-front premiums. System will be implemented in Fiscal Year 1997. Also started development of the Premium Collection System for periodic premiums which is scheduled for completion by the end of Fiscal Year 1998.

rather slow pace. FHA currently has 45 systems in use that have to be maintained. While a strategic plan for achieving integration of systems has been developed, there are challenges in managing budgetary and other resources to meet the day-to-day demands of program areas while at the same time focusing on changes and development that need to take place to achieve integration. Through the use of its strategic plan, FHA plans to continue to prioritize enhancements to systems and development to assure that integration goals are achieved. FHA's Strategic Plan targets the end of Fiscal Year 1998 for integration of its systems.

Status of Efforts

The goal of achieving total financial systems integration moves at a

V. Supplemental Credit Reform Information

Federal Housing Administration

Supplemental Credit Reform Information

as of September 30, 1996

FHA operates the following loan and loan guarantee programs:

(1) Mutual

MMI - Mutual Mortgage Insurance

CMHI - Cooperative Management Housing Insurance

(2) Subsidized

GI - General Insurance

SRI - Special Risk Insurance

Direct loan obligations or loan guarantee commitments made prior to Fiscal Year 1992 and the resulting direct loans or loan guarantees are reported net of allowance for estimated uncollectable loans or estimated losses.

Direct loan obligations or loan guarantee commitments made after Fiscal Year 1991 and the resulting direct loans or loan guarantees are governed by the Federal Credit Reform Act of 1990, as amended. The Act provides that the present value of the subsidy costs (i.e., interest rate differentials, interest subsidies, estimated delinquencies and defaults, fee offsets, and other cash flows) associated with direct loans and loan guarantees be recognized as a cost in the year the direct or guaranteed loan obligated in the budget is disbursed.

An analysis of loans receivable, loan guarantees, liability for loan guarantees, and the nature and amounts of the subsidy and administrative costs associated with the loans and loan guarantees are provided in the following sections. In some cases, expenses and liabilities are negative because the present value of the cash inflows is greater than the present value of the related cash outflows.

Direct Loans Obligated Prior to FY 1992 (Allowance for Loss Method):

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance For Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
(1) Mutual (MMI/CMHI)	$12,083	$3,595	($6,252)	$0	$9,426
(2) Subsidized (GI/SRI)	$106,421	$47,224	($77,914)	$0	$75,731
Total	$118,504	$50,819	($84,166)	$0	$85,157

Direct Loans Obligated After FY 1991:

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loans
(1) Mutual (MMI/CMHI)	$2,131	$0	$0	($300)	$1,831
(2) Subsidized (GI/SRI)	$183	$0	$0	($23)	$160
Total	$2,314	$0	$0	($323)	$1,991

Defaulted Guaranteed Loans from Pre-1992 Guarantees:

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance For Loan Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Assets, Net
(1) Mutual (MMI/CMHI)	$1,918,709	$604,910	($903,103)	$602,251	$2,222,767
(2) Subsidized (GI/SRI)	$3,508,021	$578,036	($2,686,850)	$150,969	$1,550,176
Total	$5,426,730	$1,182,946	($3,589,953)	$753,220	$3,772,943

Defaulted Guaranteed Loans from Post-1991 Guarantees:

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Defaulted Guaranteed Loans Receivable
(1) Mutual (MMI/CMHI)	$867,867	$71,780	$346,830	($314,068)	$972,409
(2) Subsidized (GI/SRI)	$160,549	$12,104	$62,223	($123,021)	$111,855
Total	$1,028,416	$83,884	$409,053	($437,089)	$1,084,264

Guaranteed Loans Outstanding:

Loan Guarantee Programs	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
(1) Mutual (MMI/CMHI)	$337,720,000	$337,720,000
(2) Subsidized (GI/SRI)	$88,313,000	$88,313,000
Total	$426,033,000	$426,033,000

Loan Guarantee Modifications and Reestimates

Loan Guarantee Programs	Modifications	Re-estimates
(1) Mutual (MMI/CMHI)	($265,492)	$180,700
(2) Subsidized (GI/SRI)	($533,713)	($109,862)
Total	($799,205)	$70,838

Total Loan Guarantee Subsidy Expense

Loan Guarantee Programs	
(1) Mutual (MMI/CMHI)	($1,850,820)
(2) Subsidized (GI/SRI)	($613,533)
Total	($2,464,353)

Administrative Expense:

Loan Guarantees (for Post - 1991 Guaranteed loans)

Loan Guarantee Programs	
(1) Mutual (MMI/CMHI)	$341,595
(2) Subsidized (GI/SRI)	$202,470
Total	$544,065

VI. Audited Financial Statements

audit report
OFFICE OF INSPECTOR GENERAL

Issue Date
March 10, 1997
Audit Case Number
97-FO-131-0002

TO: Nicolas P. Retsinas, Assistant Secretary for Housing - Federal Housing Commissioner, H

FROM: James A. Heist, Director, Financial Audits Division, GAF

SUBJECT: Audit of the Federal Housing Administration's Fiscal Year 1996 Financial Statements

This report presents the results of KPMG Peat Marwick LLP's (KPMG) audit of the Federal Housing Administration's (FHA) financial statements for the year ended September 30, 1996. We concur with KPMG's opinion, that the financial statements present fairly, in all material respects, FHA's financial position and results of its operations, and cash flows for the year then ended, in conformity with generally accepted accounting principles.

FHA is headed by HUD's Assistant Secretary for Housing/Federal Housing Commissioner, who reports to the Secretary of the Department of Housing and Urban Development (HUD). FHA is organized into four major mortgage insurance fund activities, with the Mutual Mortgage Insurance Fund, which provides single family insurance, as the largest activity. The Assistant Secretary for Housing is also responsible for administering significant non-FHA programs, such as the Section 8 Rental Assistance, Section 202 Supportive Housing for the Elderly and Section 811 Supportive Housing for Persons with Disabilities programs. Activities relating to these other programs are not included in FHA's financial statements but are covered in HUD's agency-wide financial statements.

Audit Scope and OMB Audit Requirements

This audit was conducted in accordance with *Government Auditing Standards* and was performed pursuant to the requirements of the Chief Financial Officer (CFO) Act and Office of Management and Budget (OMB) Bulletin No. 93-06, *Audit Requirements for Federal Financial Statements*. To complete this audit, we contracted with the independent certified public accounting firm of KPMG Peat Marwick LLP (KPMG). We approved the scope of the audit work, monitored its progress at key points, reviewed KPMG's working papers, and performed other procedures we deemed necessary.

OMB set forth audit requirements in Bulletin No. 93-06 that exceed ***Government Auditing Standards,*** primarily in two areas. These relate to:

- expanding the review of FHA's internal controls and
- reviewing performance measures contained in FHA's annual report.

To address the first additional OMB requirement, we engaged KPMG to expand their review of FHA's internal controls. The section discussing internal controls presents the results of this work. To address the second additional requirement, OIG is performing procedures required by OMB Bulletin No. 93-06. Because FHA's annual report is not yet complete, our review is ongoing and the results of our review will be reported at a later date.

Results of KPMG's Audit

In addition to KPMG's unqualified opinion on FHA's financial statements, the audit results were similar to those reported in prior years. KPMG reported three material weaknesses and three reportable conditions on internal controls and one issue of non-compliance with laws and regulations. KPMG's report discusses each of these issues in detail, provides an assessment of actions taken by FHA to mitigate them and makes recommendations for corrective actions. During the course of the audit, KPMG also identified several matters which, although not material to the financial statements, are being communicated to us and FHA management separately.

Recommendations and Follow-up on Prior Audits

In audit reports on FHA's prior years' financial statements, various recommendations were presented to address FHA's internal control weaknesses and non-compliance with laws and regulations. While FHA has taken certain actions to address these recommendations, corrective actions were incomplete. In accordance with the Department's Audits Management System, we will continue to track the resolution of these prior years' audit recommendations.

For the Fiscal Year 1995 audit, KPMG furnished a separate document detailing their recommendations relevant to that audit. For the Fiscal Year 1996 audit, KPMG incorporated their recommendations directly into their report. The recommendations from the Fiscal Year 1996 audit may, in fact, cover many of the same issues described in the Fiscal Year 1995 recommendations. FHA's management should review all outstanding recommendations and determine a correct course of action which responds to the current status of all open findings.

To the extent that these recommendations do not substantially repeat recommendations issued under prior audits of FHA's financial statements, we will issue a separate memorandum restating and numbering these recommendations to facilitate their tracking in the Departmental Automated Audits Management System.

Comments of FHA Officials

On January 31, 1997 we provided a draft of KPMG's report to FHA officials for their review and comment. FHA officials responded in a memorandum dated March 5, 1997 and largely agreed with the findings and recommendations. FHA's comments are presented in their entirety as Exhibit A to this report.

We appreciate the courtesies and cooperation extended to the KPMG and OIG audit staff during the conduct of the audit.

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INDEPENDENT AUDITORS' REPORT

To the Inspector General,

U.S. Department of Housing and Urban Development:

We have audited the 1996 and 1995 consolidated financial statements of the Federal Housing Administration (FHA). The objective of our audits was to express an opinion on the fair presentation of FHA's consolidated financial statements. In connection with our audits we also considered FHA's internal controls and tested FHA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its consolidated financial statements.

In our opinion, FHA's 1996 and 1995 consolidated financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

During our consideration of internal control and our tests of compliance with certain laws and regulations, we noted:

- material weaknesses in internal control related to:
  - ⇒ addressing staff and administrative resource issues,
  - ⇒ placing more emphasis on early warning and loss prevention regarding the insured portfolio, and
  - ⇒ improving accounting and financial management systems;
- reportable conditions related to:
  - ⇒ resolving Secretary-held single and multifamily mortgages and minimizing additional mortgage note assignments,
  - ⇒ monitoring and accounting for single family property inventory, and
  - ⇒ performing a review of processing. controls for computer systems and place more emphasis on computer security; and
- non-compliance with a data requirement of the Credit Reform Act of 1990.

Our opinion on FHA's consolidated financial statements, our consideration of internal control, our tests of FHA's compliance with certain laws and regulations, and our responsibilities are discussed in the remainder of our report.

OPINION ON CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated statements of financial position of FHA, as of September 30, 1996 and 1995, and the related consolidated statements of operations, changes in government equity (deficiency), and cash flows for the years then ended. These consolidated financial statements are the responsibility of FHA's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

In our opinion, the accompanying 1996 and 1995 consolidated financial statements present fairly, in all material respects, the financial position of FHA as of September 30, 1996 and 1995, and the results of its operations, and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual funds. The consolidating information is not a required part of the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

INTERNAL CONTROLS

We noted certain matters involving internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions are matters coming to our attention that, in our judgment, relate to significant deficiencies in the design or operation of internal control and could adversely affect FHA's ability to record, process, summarize, and report financial data consistent with the assertions of management in the consolidated financial statements.

A material weakness is a reportable condition in which the design or operation of specific internal control elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the consolidated financial statements of FHA may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of internal control would not necessarily disclose all matters related to internal control that might be reportable conditions and, accordingly, would not necessarily disclose all material weaknesses as defined above. However, we noted matters involving internal control that we consider to be material weaknesses as described above.

These material weaknesses, which apply to the single family and multifamily programs in varying degrees as addressed by program area in Appendix A, exist in three major interrelated areas, as compared to four areas noted in 1995. As a result of improvements and changing conditions and environments, one previous matter considered a material weakness is currently assessed to be a reportable condition. Material weaknesses are:

- ***FHA must address staff and administrative resource issues.*** FHA must review its staffing levels, personnel skills versus skill needs, and training resources. These resource issues, which are complicated by national initiatives towards a smaller Federal government, which require staff reductions, prevent FHA from placing adequate resources on multifamily loss mitigation functions, properly managing troubled multifamily assets, and quickly implementing new automated systems. Concurrently, FHA must address the impact of consolidating single family operations.

- ***FHA must place more emphasis on early warning and loss prevention for insured mortgages.*** FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure troubled multifamily mortgages before they become seriously delinquent and by improving risk management for the single family insured portfolio.

- ***FHA must improve accounting and financial management systems.*** Some of FHA's automated systems either do not provide needed management information or do not produce reliable information. Better information systems for strategic decision-making would make monitoring more productive and staff more efficient.

Appendix A shows these weaknesses by program area and discusses them further.

Although not considered material weaknesses, three reportable conditions are reported in Appendix B. These reportable conditions include one item repeated from our prior year report, one item reclassified from a material weakness, as noted above, and one new reportable condition. These reportable conditions are summarized as follows:

- ***FHA must continue actions to quickly resolve Secretary-held mortgage notes and minimize additional mortgage note assignments and note servicing responsibilities.*** Servicing and managing defaulted mortgage notes assigned to FHA requires significant resources. The diversion of resources to service the Secretary-held note portfolios reduces resources available to monitor insured mortgages resulting in additional claim payments.

- ***FHA must sufficiently monitor and account for single family property inventory.*** FHA has control weaknesses in its single family property acquisition, management, and disposition functions. These and other control weaknesses have (a) decreased FHA's ability to effectively monitor, control, and report accurately on the Single Family Property Division's activities, (b) increased the risk of loss to FHA on the sales of its single family properties, (c) caused data input errors and incomplete data fields in the SAMS system, and (d) caused inefficiencies due to the need for expansive clean-up efforts to address data integrity problems.

- ***FHA must perform a review of processing controls for computer systems and place more emphasis on computer security.*** Control weaknesses exist in overall and application level security in FHA's electronic data processing environment.

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 1996 consolidated financial statements. We have not considered internal control subsequent to the date of this report.

Although not considered reportable conditions, we also noted other matters during our audit, which will be reported to FHA's management in a separate letter.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests, performed as part of obtaining reasonable assurance about whether the consolidated financial statements are free of material misstatement, disclosed the following instance of noncompliance that is required to be reported herein under *Government Auditing Standards* and the Office of Management and Budget (OMB) Bulletin No. 93-06.

FHA is not in compliance with a data requirement of the Credit Reform Act of 1990. The Credit Reform Act (Credit Reform) requires that FHA track the cash flows related to its insurance portfolio cohorts (books of business) and risk categories (projects with similar risk characteristics) at the case level. FHA's single family periodic premiums system cannot generate the required case-specific cash flow data required to reestimate its subsidies properly. This data is allocated to cohorts and risk categories using cash flow estimates, rather than actual cash flows. FHA maintains all other data used to calculate Credit Reform subsidies at the required case-specific level. FHA must obtain OMB concurrence with its recently proposed corrective action plan and must implement the plan.

This matter is discussed further in Appendix C.

This matter was also noted in our report on the 1995 consolidated financial statements dated May 20, 1996. We considered this instance of noncompliance in forming our opinion on whether FHA's 1996 consolidated financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

RESPONSIBILITIES

Management's Responsibility. The Chief Financial Officers (CFO) Act of 1990 requires federal agencies to report annually to Congress on their financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet the CFO Act reporting requirements, FHA prepares annual consolidated financial statements. FHA is an agency operated by the U.S. Department of Housing and Urban Development (HUD).

Management has the responsibility for:

- preparing the consolidated financial statements in conformity with generally accepted accounting principles;
- maintaining adequate internal control designed to fulfill control objectives; and
- complying with applicable laws and regulations.

In fulfilling these responsibilities, estimates and judgments by management are required to assess the expected benefits and related costs of internal control. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that:

(1) transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;

(2) funds, property, and other assets are safeguarded from unauthorized use or disposition; and

(3) transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the consolidated financial statements.

Auditors' Responsibility. Our responsibility is to express an opinion on the 1996 and 1995 consolidated financial statements of FHA. We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 93-06, except for those portions of the Bulletin that relate to the review of performance measures. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and presented fairly in accordance with generally accepted accounting principles. We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our audit of the consolidated financial statements of FHA, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on internal control.

As part of obtaining reasonable assurance about whether the consolidated financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws and regulations. However, the objective of our audit of the consolidated financial statements, including our tests of compliance with certain provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and

- disclosures in the financial statements;

- assessed the accounting principles used and significant estimates made by management;

- evaluated the overall financial statement presentation;

- obtained an understanding of the design of significant internal controls, determined whether they have been placed in operation, assessed control risk, and performed tests of the internal controls; and

- tested compliance with certain provisions of laws and regulations that could have a direct and material affect on the consolidated financial statements.

Because of inherent limitations in any system of internal control, errors or irregularities may nevertheless occur and not be detected. Also, controls found to be functioning at a point in time may later be found deficient because of the performance of those responsible for applying them, and there can be no assurance that controls currently in existence will prove to be adequate in the future as changes take place in the organization.

This report is intended solely for the use of the HUD Office of the Inspector General, the management of HUD and FHA, and Congress. However, this report is a matter of public record and its distribution is not limited.

March 4, 1997
Washington, D.C.

INTRODUCTION

Material weaknesses in FHA's internal control are summarized in the three categories discussed below:

- ***FHA must address staff and administrative resource issues.*** FHA must review its staffing levels, personnel skills versus skill needs, and training resources. These resource issues, which are complicated by national initiatives towards a smaller Federal government, which require staff reductions, prevent FHA from placing adequate resources on multifamily loss mitigation functions, properly managing troubled multifamily assets, and quickly implementing new automated systems. Concurrently, FHA must address the impact of consolidating single family operations.

- ***FHA must place more emphasis on early warning and loss prevention for insured mortgages.*** FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure troubled multifamily mortgages before they become seriously delinquent and by improving risk management for the single family insured portfolio.

- ***FHA must improve accounting and financial management systems.*** Some of FHA's automated systems either do not provide needed management information or do not produce reliable information. Better information systems for strategic decision-making would make monitoring more productive and staff more efficient.

These three material weaknesses, in addition to the three reportable conditions noted in Appendix B, are interrelated in that note can be effectively addressed without addressing the others. Additionally, these weaknesses apply to the single family and multifamily programs in varying degrees.

The internal control weaknesses discussed in this report, and FHA's progress toward correcting these weaknesses, are discussed in the context of FHA's existing statutory and organizational structure. As of the date of this report, it is unclear (1) how legislative and budgetary changes will impact FHA, and (2) what effect such changes may have on FHA's ability to implement existing or future corrective action plans.

FHA continued to make progress in addressing material weaknesses during 1996. Most notably, as a result of the success achieved in reducing the Secretary-held note inventory through the note sale program, a previous matter considered a material weakness relating to this issue has been reclassified to a reportable condition. Other progress relating to each of the remaining material weaknesses is noted in the following text.

As reported in prior years, implementing sufficient change to mitigate the internal control weaknesses is a multiyear task due to the complexity of the issues and impediments to change that FHA and HUD face. These impediments involve required interaction with large numbers of relevant constituencies outside of HUD and resource constraining actions which can affect the timing of corrective action plan implementation. Notwithstanding the impact of forces from the outside, FHA must continue to address its own self-imposed impediments to achieving necessary change. Additionally, FHA should discuss such change with a 'sense of urgency." Our concluding comments to this section of the report discuss barriers we believe can be overcome. Specifically discussed are human resource accountability, measurement, and motivation; elimination of redundancies in business processes; and using process reengineering to streamline procedures and focus on results.

The following sections include a description of each material weakness; FHA's action plans and significant actions to correct the deficiency; our assessment of planned and completed actions undertaken by FHA as of the date of this report; and our recommendations. This section concludes with our comments and recommendations for additional efficiency gains.

FHA MUST ADDRESS STAFF AND ADMINISTRATIVE RESOURCE ISSUES

Unlike private institutions or government-sponsored enterprises involved in housing credit, FHA does not have the authority to hire staff or invest more resources in automated tools or staff training when transaction volume increases. Nor can FHA quickly or easily change the structure of its mortgage insurance programs to reduce staff-intensive functions and promote efficiency. In such an environment, critical credit and asset management functions suffer. Resource restrictions that increase the risk of borrower default or the cost of servicing and disposing of assets are fundamentally at odds with cost effective credit management

FHA's staffing issues are multifaceted and include (a) staffing shortages in some areas, (b) barriers to effective staff redeployment, (c) mismatches between skill sets and skill needs, and (d) collective bargaining agreements. These staff and administrative resource issues will be compounded as anticipated budget restrictions lead to reductions in HUD staff from the current level of 10,494 at the end of fiscal year 1996 to an anticipated 7,500 by the end of fiscal year 2000. FHA's staffing needs continue to be most critical in the Multifamily insured portfolio monitoring area and, to a lesser degree as a result of the loan sales program, in the multifamily Secretary-held note servicing area. The Single Family issues center primarily around staff utilization and redeployments.

Multifamily

Multifamily Action Plans and Significant Actions to Address Resource Issues

FHA's Office of Multifamily Housing (Multifamily) staff and administrative resource issues result from resource pressures to develop new business and programs, monitor current insured mortgages, plan for Section 8 contract expirations, and manage the Secretary-held note and property inventories. Specific matters related to monitoring the insured portfolio and loss prevention are discussed later in this Appendix. FHA's ongoing plans to address staff and administrative resource issues are described below:

- *Provide better information.* As more fully described later, Multifamily has identified, designed, and implemented strategies for providing field offices better information for more effective and efficient portfolio management. In fiscal year 1996, Multifamily completed a Business Area Analysis project to identify the information systems needed for business development and management and to develop plans to implement such systems. All field offices are expected to have access and training for use of the recently implemented Multifamily Data Warehouse by the end of 1997. A Data Quality Team has also been established to address issues concerning inaccurate or incomplete information in the Data Warehouse.

- *Reengineer and streamline processes.* In fiscal year 1997, Multifamily commissioned a reengineering team to streamline processes and procedures to gain efficiencies while maintaining adequate internal controls.

- *Redistribute existing workload among field offices.* During fiscal year 1996, FHA began redistributing location neutral work among field offices. Under this plan, FHA created five regional matrix teams designed to maximize flexibility and resource utilization. Multifamily expects to (1) increase field office participation in decision-making, (2) improve resource flexibility, and (3) equalize workloads.

- *Establish Hubs to consolidate certain field office operations.* Multifamily has identified processing functions that can be consolidated into a few centralized field offices to capitalize on economies of scale and reduce inefficient and redundant uses of field office personnel. Expansion of the prototype Voucher Processing Hub (VPH) into a permanent organization was approved by the Office of Housing in October 1996. The VPH is currently being expanded by transferring voucher processing workloads from 58 field offices on an office-by-office basis. In addition, the VPH is scheduled to assume responsibility for payment review and approval from 10 Field Accounting Divisions. The VPH will be fully expanded in December 1997. In addition, during fiscal year 1996, HUD established two Property Disposition Hubs in Atlanta and Ft. Worth to manage and dispose of multifamily properties.

- *Outsource physical inspections.* In fiscal year 1997, FHA issued four national contracts to perform annual inspections for all insured multifamily projects. During fiscal year 1997, half of the insured multifamily portfolio of approximately 15,000 projects are scheduled for physical inspections. Special priority will be given to projects with expiring Section 8 contracts. Previously, these inspections were performed by HUD personnel, mortgagees, and regional contractors.

- *Use specialized asset managers.* In fiscal year 1997, FHA plans to provide field offices access to consultants who specialize in complex multifamily restructuring agreements, real estate experts, finance and tax administrators, legal representatives, and asset managers.

- *Obtain additional mortgagee cooperation.* Multifamily plans to delegate additional portfolio management responsibilities to mortgagees. Increased mortgagee involvement translates into resource and cost savings for FHA. These efforts include requiring mortgagees to provide delinquency, default, assignment election, physical inspection, and reinstatement data electronically to reduce data entry by October 1997.

- *Continue the asset sales strategy.* As discussed later in this report, Multifamily will continue to sell its inventory of notes, thus freeing note servicing staff for other critical functions.

KPMG's Assessment of Planned and Completed Multifamily Actions

During fiscal year 1996, Multifamily continued to address staff and resource issues identified in our prior year report. However, because many of these plans were in their early stages, credit and asset management functions continued to suffer. Bid protests and litigation also set back Multifamily's timely procurement of contractor services, further slowing its efforts.

Shifting work to specialized private sector professionals, consolidating functions through the use of Hubs, and selling Secretary-held notes will reduce staff workloads at field offices. However, this capacity is expected to be absorbed quickly by new portfolio reengineering initiatives to be conducted using field office personnel.

The Multifamily Data Warehouse was released to field offices in November 1996. However, until training to enhance awareness and use of information is provided to field office personnel, effective and efficient use of the data warehouse will not occur. The data warehouse also has problems with incomplete or inaccurate data. Multifamily has plans to complete training for field office personnel by April 1997, and has begun an effort to scrub current databases for inaccurate and incomplete information.

The assembly of a reengineering team demonstrates Multifamily's commitment to streamline operations to address staff and resource shortages. However, streamlining needs to be planned carefully and implemented quickly to be effective during this period of HUD downsizing.

In April 1998, contracts for the contractor-operated Multifamily Accounting Reporting System (MARS) and the Property Management System (PMS) expire. These systems are used to manage FHA's multifamily Secretary-held note and property portfolios. FHA has exercised its last renewal option on these contracts. Even though FHA expects to continue liquidating multifamily Secretary-held note and property portfolios, FHA has a critical need for the financial and operational information existing systems provide.

FHA is currently considering three options for replacing the expiring contracts: (1) procuring services of a third party servicer, (2) obtaining off-the-shelf software for in-house note servicing and property management, and (3) adapting the single family F-6O note servicing system for the multifamily Secretary-held note portfolio.

KPMG's Multifamily Recommendations

We recommend that FHA:

- Develop and use outcome measures to evaluate the effectiveness of actions taken by matrix teams. These measures should relate to the mission of Multifamily programs, rather than simply track tasks performed. Teams and individuals should be empowered to take selective actions, and be held accountable and rewarded for results achieved. Outcome measures could include tracking the number of insured projects ranked as poor or substandard and the number of troubled and potentially troubled projects at each field office.

- Invite information systems technology experts and key user groups to participate in reengineering plans and initiatives. Reengineering teams should also solicit input from the Inspector General's office on the sufficiency of internal controls over the new streamlined procedures.

- Select and implement a plan to ensure timely replacement for MARS and PMS contracts expiring in 1998. This plan should cover anticipated transaction activities, software and hardware requirements, staffing needs, and the timely acquisition of historical records held by the existing contractor.

- Develop a formal, comprehensive, Multifamily human resource training strategy that:
  - ◊ assesses staff developmental needs by identifying gaps between skill sets needed and existing skill sets;
  - ◊ includes a complete training program for all personnel performing multifamily functions;
  - ◊ includes a building block type of educational path that provides continuing education certification; and
  - ◊ identifies specific performance measures for use in employee evaluation and promotions.

Single Family

Single Family Action Plans and Significant Actions to Address Resource Issues

FHA's Office of Single Family Housing has taken several critical steps toward addressing its operational resource issues. A reorganization plan was developed to consolidate most functions involving loan processing, quality assurance, and asset management into Homeownership Centers by the year 2000. This plan will reduce Single Family Housing personnel by more than 50 percent. To manage risk effectively while rapidly downsizing, FHA must continue its current progressive initiatives and identify and incorporate other opportunities for operational efficiencies.

In April 1996, Congress enacted legislation that eliminated the mortgage assignment program for mortgages insured through the end of fiscal year 1996. On September 29, 1996, the 1997 Appropriations Bill extended the legislation to eliminate eligibility for the assignment program for loans insured through September 30, 1997. This extension allows FHA to reallocate resources previously used for assignment processing and note servicing to more effective and cost beneficial loss mitigation efforts. FHA has also taken the following steps:

- *Continue single family Secretary-held mortgage note sales.* During fiscal year 1996, FHA completed three single family mortgage note sales, and plans three additional sales for fiscal year 1997 (further details are provided in Appendix B). The disposition of mortgage notes lessens the workload and responsibilities of loan servicers and may eventually lead to their redeployment to other areas of FHA's operations. FHA plans to consolidate all single family note servicing into one Homeownership Center and to redirect those currently performing single family mortgage loan servicing functions by the close of fiscal year 1997.

- *Continue the consolidation process.* FHA plans to consolidate loan processing, quality assurance, asset management, and other operations from 80 field offices, into the three current Homeownership Centers and perhaps add two more centers. The Denver Homeownership Center, opened in 1995, consolidated routine, location-neutral single family origination functions from 17 field offices in the Southwest and Rocky Mountain regions, demonstrating the efficiencies achievable through consolidation and specialization. The evolutionary structure of the Homeownership Centers is designed to consolidate and augment the current headquarters and field office structure with efficient customer service operations. Transition to the Homeownership Center structure is planned to be complete at the end of fiscal year 1999, as summarized below:

	Denver	**Philadelphia**	**Atlanta**	**#4**	**#5**
Loan Processing	Completed	Completed	Completed	3rd Q 1997	3rd Q 1997
Quality Assurance	Completed	3rd Q 1997	3rd Q 1997	2nd Q 1998	2nd Q 1998
Asset Management	3rd Q 1998	1st Q 1999	1st Q 1999	4th Q 1999	4th Q 1999
Number of Field Offices Consolidated	17	18	14	15	16

- *Continue Electronic Data Interchange (EDI) Implementation.* FHA uses EDI to accept single family claims for insurance benefits, receive monthly mortgage loan default status reports, change records, and terminate mortgage insurance. The use of EDI in lieu of paper or magnetic formats results in fewer errors, enhances data integrity, and reduces labor-intensive processing for FHA staff. The following FHA EDI initiatives should be completed and fully operational by the end of 1997, as summarized below:

Single family EDI Application	**Date EDI Submission is Mandated**
Claims for insurance benefits	6/1/97
Monthly mortgage loan default status reports	12/31/97
Mortgage record changes	12/31/97
Mortgage insurance terminations	12/31/97

Conversion of other key FHA business processes to EDI is planned for fiscal year 1997 and beyond.

- *Develop the Single Family Data Warehouse.* During the fourth quarter of 1996, FHA hired a contractor to design and implement a data warehouse that will allow users easy access to data from 11 different single family data systems. The data warehouse will provide information to analyze loss mitigation, default, claim, and other data necessary to manage the insured portfolio effectively and to focus lender monitoring and post-technical reviews on high-risk lenders. Development and implementation is scheduled to continue through 1997 and 1998.

- *Revise FHA's property disposition function.* FHA is evaluating several alternatives to revise its process for managing the disposition of single family properties acquired through conveyances and foreclosures. Possibilities include: (1) contracting out the property disposition function to the private sector; (2) privatizing the property management and disposition process through joint ventures with other organizations; and (3) acquiring and selling the defaulted mortgage notes rather than acquiring the properties.

  FHA's objective is to (a) increase the return on the disposition of properties; (b) allow for anticipated personnel reductions in the asset management and disposition areas; and (c) improve the process.

  In fiscal year 1997, FHA began a pilot program to contract out asset management and property disposition functions in several field offices. Results will be used to evaluate the benefits of further contracting these services to the private sector.

KPMG's Assessment of Planned and Completed Single Family Actions

As discussed in detail in Appendix B, FHA reduced the single family note portfolio by approximately 43 percent through note sales in fiscal year 1996. FHA should begin to see the benefits of reduced note servicing workloads in 1997. Extending the termination of the assignment program will prevent further additions to the Secretary-held mortgage note portfolio for loans insured through September 30, 1997; if the program is terminated completely, note servicing staff can be significantly reduced. However, as discussed in Appendix B, actions are needed to ensure that the assignment program is terminated beyond fiscal year 1997. Also, third parties have initiated legal actions to require FHA to reinstate the mortgage assignment program pursuant to a 1979 consent decree under the Ferrell litigation.

In July 1996, the field offices had a backlog of over 6,000 applications eligible for the assignment program. The Office of Single Family Housing established a national target to complete all applications by the end of fiscal year 1997. Completing these applications is a critical part of resolving the inefficiencies and administrative burdens of the mortgage note assignment program.

The transfer of workloads from the field offices to the Homeownership Centers is in its early stages and FHA faces significant challenges, including obtaining union concurrence on the plan, before it can realize many of the benefits. Once fully adopted by a majority of mortgagees, EDI initiatives will create operating efficiencies for both FHA and its mortgagees. However, EDI has only been mandated recently and some implementation issues continue to offset the efficiencies gained. Finally, FHA will not realize benefits from the Single Family Data Warehouse and the property management and disposition process revisions until these initiatives have matured.

KPMG's Single Family Recommendations

We recommend that FHA:

- Continue its timely transition to Homeownership Centers for streamlining operations, serving FHA's customers, and providing quality services and information to both FHA's internal and external customers.

- Finalize its strategy to revise the single family asset management and property disposition process and develop an implementation plan with specific goals and timelines. Any strategy to contract services to the private sector must include controls to monitor contractor performance.

- Conduct working group sessions with lenders to identify areas of FHA operations that can be further streamlined (e.g., claims processing and property disposition processes).

- Analyze all transactions and communications between FHA, lenders, and other partners, to identify additional opportunities to expand the use of EDI (e.g., data used for delegated underwriting) and transmitting business correspondence.

- Coordinate with Ginnie Mae as it develops its EDI initiatives and evaluate opportunities for mutual efficiencies.

- Review the transaction processes that have been automated using EDI to determine the feasibility of reengineering the process to reduce staff time and eliminate unneeded steps (e.g., even though claim forms for insurance benefits must be submitted using EDI by June 1, 1997, mortgagees will still be required to send paper claims to field offices).

- Develop a comprehensive human resource strategy that:
    - ◊ plans for resource deployment upon realizing efficiencies of current initiatives;
    - ◊ contemplates skill sets needed versus existing skill sets, to identify gaps;

  - ◊ contains a comprehensive training program for personnel performing single family functions; and
  - ◊ identifies specific performance measures for single family personnel that are linked to their roles and responsibilities under the new structure and FHA's overall objectives of increasing homeownership.

- Improve servicing on the single family notes remaining in inventory using resources freed up by note sales. Improved note servicing and collection activities should improve the payment histories of notes in inventory, thereby increasing the value to FHA in future dispositions. Communication from management emphasizing the importance of servicing activities may be needed, given the number of organizational changes occurring at FHA, including the consolidation of all single family note servicing into the Atlanta Homeownership Center.

FHA MUST PLACE MORE EMPHASIS ON EARLY WARNING AND LOSS PREVENTION FOR INSURED MORTGAGES

FHA does not have adequate systems, processes, or resources to identify and manage risks in its insured portfolios effectively. Timely identification of troubled insured mortgages is a key element of FHA's efforts to target resources to insured mortgages that represent the greatest financial risks to FHA. Troubled insured mortgages must be identified before FHA can institute loss mitigation techniques that can reduce eventual claims.

Multifamily

Multifamily Action Plans and Significant Actions to Improve Monitoring and Early Warning Loss Prevention

FHA's monitoring of the multifamily insured and Secretary-held mortgage note portfolios relies heavily on personnel in the field offices. When done timely, risk-ranking the multifamily insured portfolio allows FHA to target its resources more efficiently to higher risk properties. This process, supplemented with additional training and detailed physical, financial, and operational information, can improve decision making for mitigating losses. Timely reviews of mortgagees with poor underwriting and claim statistics can also enhance quality control, decrease risk, and minimize losses.

Multifamily has the following plans to improve early warning and loss prevention efforts:

- *Continue to implement the portfolio reengineering demonstration program.* In September 1996, Congress extended FHA's authority to proceed with the Portfolio Reengineering Demonstration Program on 50,000 units with expiring Section 8 contracts. The demonstration program will use a variety of tools and authorities to restructure the financing of assisted FHA-insured projects to prevent or reduce claims upon Section 8 contract expiration. (See Appendix B)

- *Develop multifamily Information systems and financial models.* As previously discussed, during fiscal year 1996, the Business Area Analysis (BAA) project was completed, and resulted in a plan to establish a suite of integrated automated systems and databases to support the Multifamily Asset Development and Management businesses. Specific initiatives include:

◊ *Multifamily Data Warehouse.* In 1996, FHA launched a data warehouse that organizes data from several incompatible multifamily data systems into one user-friendly information clearinghouse to enhance decision support capabilities and information dissemination. The warehouse allows inquiry by property, property owner, servicer, geographic area, type of property, and other variables. Although the warehouse is in operation and is updated regularly, access is currently available only to certain pilot field offices. Full implementation is expected during 1997.

◊ *Risk Assessment Management System (RAMS).* Using information from audited financial statements, physical inspections, and management reviews, RAMS ranks multifamily mortgages allowing asset managers to target loss mitigation efforts to the riskiest mortgages. RAMS was piloted in five offices during fiscal year 1996, and full implementation should be completed by the end of fiscal year 1997.

◊ *Community Wizard.* Community Wizard uses information from numerous government sources, including census data and welfare subsidy databases, to identify overlapping government subsidies. Information from this external proprietary system will be used to develop place-based risk mitigation strategies.

◊ *Section 221(g)(4) Portfolio Analysis.* FHA has commissioned an economic model to identify optimal solutions for disposing of Section 221(g)(4) mortgages assigned to FHA. Mortgagees may assign Section 221(g)(4) mortgages to FHA at the end of 20 years if the loan is then current. Until recently, FHA had been able to use auction authority to perform reflector sales by keeping the project's insurance in-force and paying interest enhancement expenses to the buyer. FHA no longer has the authority to perform these reflector sales and is therefore evaluating new methods to prevent the assignment of these mortgages.

- *Use Special Workout Assistance Teams (SWAT).* FHA has established SWAT teams that travel to field offices to review insured and Secretary-held portfolios, identify and resolve troubled and potentially troubled projects, and to provide loss prevention training to asset managers. To date, 451 of the most troubled properties have been reviewed. In addition to reviewing individual properties nominated by field offices, SWAT is also reviewing entire portfolios of certain property owners. Multifamily's goal is to remove every troubled and potentially troubled project from its insured portfolio over the next four years.

- *Increase coordination of oversight and monitoring of the New York state hospital portfolio.* During fiscal year 1996, FHA formed an agreement with the Dormitory Authority of New York State to enhance the coordination and oversight of the New York state hospital portfolio. During fiscal year 1997, FHA expects to finalize a similar interagency agreement with the United States Department of Health and Human Services.

- *Award legal enforcement contracts.* In January 1996, FHA awarded a legal enforcement contract that provides resources to FHA and HUD's Officer of General Council (OGC) staff, to pursue enforcement actions against negligent owners. To date, 75 projects have been refereed under the contract and another 15 projects are under consideration.

- *Disseminate data used for loss reserve estimation.* Information prepared at FHA headquarters for calculating loss reserves can be valuable in identifying troubled and potentially troubled projects. In 1997, this information will be provided to field offices for analysis in hard copy and electronic versions.

- *Implement "place-based" development programs.* "Place-based" programs mitigate losses by improving neighborhoods and stabilizing real estate values through enhanced resident morale, safety, education, or job training. An example is the "Neighborhood Networks" program which develops computer leaning centers in HUD insured and assisted housing projects. Since the implementation of the program, 92 neighborhood network centers have become operational. During 1997, Multifamily's goal is to implement two new Neighborhood Network Centers per field office. Additionally, the Safe Neighborhood Action Plan (SNAP) initiative launched in partnership with the U.S. Conference of Mayors and the National Housing Management Association continues to address crime and drug problems plaguing assisted housing projects. SNAP initiatives include community policing, crime prevention, and individual development and job skill training programs.

KPMG's Assessment of Planned and Completed Multifamily Actions

Although the SWAT teams have made progress monitoring troubled and potentially troubled projects, the inventory of these projects remains high. Additionally, deficiencies identified during property management and financial statement reviews and physical inspections are not followed up conscientiously. Aggressive plans to continue the SWAT efforts during 1997 should cure some projects. However, it should be noted that SWAT efforts can accelerate claim filings against FHA, leading to further increases in workload of field office personnel.

KPMG's Multifamily Recommendations

We recommend that FHA:

- Make aggressive use of the contractor support recently made available to field offices to ensure that physical inspections and other required procedures are performed for all insured and Secretary-held portfolios during fiscal year 1997.

- Develop and implement a Multifamily quality assurance group similar to the successful Single Family Quality Assurance Division.

- Provide more specific and structured "building block" style training to its field office staff. Specific training and guidance should be developed to show how data warehouse and risk ranking information can be used for loss mitigation and the identification and ultimate resolution of troubled or potentially troubled projects.

Single Family

Single Family Action Plans and Significant Actions to Improve Monitoring and Early Warning and Loss Prevention

The single family area continues to experience some of the same problems as the multifamily area, but to a lesser degree. To address many of these problems the Office of Single Family Housing has developed a quality control mechanism—the Quality Assurance Division (QAD). Additionally, although the single family insured mortgage portfolio is large, automated monitoring using statistical and trend analysis can be used effectively.

To reduce claims and losses to FHA and monitor the insured portfolio of single family mortgage notes more effectively, FHA has planned or taken initiatives to:

- *Utilize new loss mitigation tools and encourage the use of existing loss mitigation tools as alternatives to mortgage foreclosure.* In April 1996, Congress authorized FHA to implement new loss mitigation tools, including partial claims and mortgage modifications, and revise requirements for existing tools to provide lenders with financial incentives to use them where appropriate. To implement loss mitigation, during 1996 FHA:
  - ◊ Established a nationwide transition team;
  - ◊ Published interim regulations in the *Federal Register;*
  - ◊ Issued a series of mortgagee letters to inform lenders about loss mitigation; and
  - ◊ Conducted loss mitigation training seminar for lenders, housing counseling agencies, and staff

FHA estimates that approximately 50 percent of seriously delinquent loans will be cured through borrower self-help and that 45 percent will avoid foreclosure through relief measures provided by loss mitigation tools, as shown below:

Loss Mitigation Effort	**Percentage of Seriously Delinquent Loans Expected to be Resolved**
Self-cured	50.0%
FHA Special Forbearance	10.0%
Partial Claim	5.0%
Refinance/Loan Modification	3.0%
Properly Sale by Owner	8.5%
Pre-foreclosure Sale	16.5%
Deed-in-lieu of Foreclosure	2.0%
Foreclosure	5.0%
Total	100.0%

- *Develop a methodology to analyze loss mitigation tool usage, performance, and effectiveness.* In conjunction with its current emphasis on using loss mitigation too1s as alternatives to foreclosure, FHA is developing a scoring system to (1) measure the cost to FHA of servicers' loss mitigation activities, (2) competitively rank comparable servicers' loss mitigation performance, and (3) provide servicers incentives to deal with defaults in a manner that is responsive to borrowers and sensitive to FHA's objectives. FHA plans to begin using this analysis to award financial incentives to lenders in March 1997.

- *Increase the QAD staff who perform on-site reviews of FHA-approved mortgagees.* During fiscal year 1996, FHA significantly increased its QAD staff from approximately 30 to over 70. At the end of fiscal year 1996, the QAD consisted of over 45 employees at headquarters and 25 at the Homeownership Center in Denver, Colorado. FHA plans to add 25 QAD employees to each of the Homeownership Centers in Philadelphia and Atlanta in 1997 and to add an additional 50 employees to the QAD during fiscal year 1998.

- *Initiate a pilot program to apply automated underwriting technology to FHA-insured loans.* During 1996, FHA initiated a pilot program in which automated underwriting was offered to a limited set of FHA mortgagees for a test period. FHA's objectives are to:

  ◊ Use technology to identify and better evaluate underserved borrowers;
  ◊ Use technology to measure and manage risk;
  ◊ Enhance FHA's research and analytical capabilities; and
  ◊ Make FHA programs more attractive for lenders and make it easier for lenders to implement and participate in FHA programs.

  FHA anticipates that automated underwriting for FHA loans will predict future borrower performance problems in a statistically sound manner. FHA is also evaluating additional automated underwriting systems for FHA insured loans.

- *Improve the Single Family Default Monitoring System (SFDMS).* The SFDMS is a key monitoring system in the single family area. This system tracks and monitors delinquency and default information at the mortgage-servicer level. FHA has identified data integrity problems with the delinquency information in SFDMS; some lenders did not report on the default status of borrowers and others reported inaccurate information. To address data integrity concerns, FHA is assessing penalties against lenders who are negligent in reporting defaulted loan information. Also, the post-claim review contractor and the QAD have increased their focus on SFDMS reporting during on-site and post-claim reviews.

  When SFDMS identifies a mortgagee or servicer with excessive default rates, FHA performs an on-site review to ensure they meet FHA standards. FHA also reviews mortgagees that have below-average "cure" rates for the mortgages they service. In addition, HUD is testing on-line reporting capabilities with direct links to mortgagees to increase the timeliness of default reporting.

- *Develop and Implement the Mortgage Portfolio Analysis System (MPAS).* During fiscal year 1996, FHA developed a system to monitor mortgagees' claim and default rates (MPAS). MPAS measures the performance of FHA-insured single family portfolios, by originating mortgagee, based on data from SFDMS. MPAS analyzes a mortgagee's national claim and default rates, within the jurisdiction of a HUD field office, by branch office of the mortgagee, by zip code, and by census tract. If a mortgagee's default and claim rates are deemed excessive (greater than 150 percent of average rates), the mortgagee is placed on credit watch status and monitored closely for a period of at least six months. FHA plans to terminate the approved status of mortgagees whose claim and default rates exceed 200 percent of the normal (average) rate for the area. Beginning in 1997, FHA will conduct a quarterly analysis of lender claim and default rates to identify poor performing lenders for follow-up.

- *Utilize a database to track and review financial stability of mortgagees.* FHA is developing a system to summarize and track key financial ratios, adjusted net worth, and other indicators of mortgagee performance. The system will be used to identify mortgagees experiencing financial difficulties and highlight negative financial trends as an early warning indicator for troubled mortgagees. This system will be one of the tools used by the QAD to identify mortgagees for on-site reviews. FHA plans to begin inputting mortgagees' financial data during 1997, and expects to have good information on trends by 1999.

KPMG's Assessment of Planned and Completed Single Family Actions

FHA's single family monitoring focuses on risk identification and actual lender and borrower performance. We believe that the plans for more effective monitoring and early warning detection capabilities will ultimately reduce claims and losses to FHA.

FHA has developed the foundation for an effective single family monitoring and early warning system. However, much remains to be done to fully implement these plans and reap their benefits. Currently, FHA cannot conduct all of the monitoring efforts discussed above to effectively enforce program compliance and mitigate claims and losses to FHA.

Lenders are just beginning to use loss mitigation tools in lieu of mortgage assignment, and FHA's current loss mitigation program and related lender performance scoring model are still evolving. FHA must use its scoring model to understand and predict the full impact of the different loss mitigation tools as an effective alternative to mortgage foreclosure and as a beneficial financial alternative to the mortgage assignment program.

The benefits of the QAD duties should become evident as the program expands, but not without the appropriate commitments to training and sufficient resource dedication to develop and implement the QAD's monitoring tools.

Automated underwriting has been used successfully by lenders for non-FHA loans and should prove successful for FHA insured loans. A statistically derived default prediction model will provide FHA with better information about the risks inherent in each book of business. However, automated underwriting for FHA loans is still in the development stages.

The full benefit of the MPAS initiative will not be realized until FHA resumes terminating origination authority for mortgagees whose claim and default rates exceed 200 percent of the average rates for the area.

Finally, the database of financial indicators for mortgagees will take several years to provide meaningful trend information that correlates indicators of weakening financial condition to appropriate follow-up and/or enforcement requirements.

KPMG's Single Family Recommendations

As recommended in prior year, we continue to recommend that FHA develop a method to estimate the ultimate financial impact of each loss mitigation tool to FHA, including the cost of financial incentives to mortgagees and a comparison to losses incurred under the assignment program.

Additionally, we recommend that FHA:

- Compare each mortgagee's claim and default rate information, provided by MPAS, to mortgagee's loss mitigation performance indicators. This analysis should reveal whether a mortgagee's high claim and default rates result from poor underwriting or poor application of loss mitigation efforts. This information can be used to direct the efforts of the QAD.

- Increase the QAD's profile with FHA mortgagees and make FHA's enforcement priorities consistent and well known. This could be accomplished in a number of ways including mortgagee letters, correspondence with mortgagees, meetings with top management during on-site reviews, and articles in industry publications. Creating awareness of these issues with mortgagees may lend to self-policing of FHA's enforcement concerns.

- Focus the QAD's enforcement actions on the accuracy of delinquency and default data submitted to FHA via EDI and the SFDMS. FHA is not confident about the quality of

SFDMS data Increased QAD attention to this mater should improve the accuracy of lender submissions.

- Explore EDI transmission of key financial ratios, adjusted net worth calculations, and other liquidity and equity measures by mortgagees. This will eliminate the time-intensive process of manually inputting the information into the database to track and review mortgagees' financial stability.

- Address adverse selection as a possible outcome of the automated underwriting process and prepare to make appropriate policy and program changes.

- Accelerate plans with private sector entities to evaluate the feasibility of developing an artificial intelligence tool to help mortgagees select the most promising loss mitigation tool (or foreclosure) for delinquent FHA-insured loans, given a borrower's current circumstances. These organizations are developing such tools for conventional lenders.

FHA MUST IMPROVE ACCOUNTING AND FINANCIAL MANAGEMENT SYSTEMS

For a number of years, weaknesses in FHA's financial management systems have been reported. Recommendations have included (1) enhancing the general ledger and subsidiary systems to facilitate better case level reporting for compliance with Credit Reform; (2) developing an integrated multifamily system that allows field offices to monitor insured and Secretary-held portfolios better (including early warning and credit risk modules); (3) fully implementing an "umbrella" system that will integrate all financial management systems; and (4) enhancing systems for reporting by program, geographical area, or other relevant components.

FHA lacks the resources to develop state-of-the-art systems because of department-wide budgetary constraints or other critical system priorities at HUD. As a result, FHA has concentrated on enhancing existing systems, and actual implementation of the plans was often a long, tedious process that did not produce timely results.

HUD Action Plans and Significant Actions to Address System Weaknesses

During fiscal years 1993 and 1994, FHA develop an overall integration strategy that management believes can be implemented within current budgetary restrictions. This strategy, Federal Housing Administration Mortgage Insurance System (FHAMIS), is a total integration strategy along program lines (Single Family, Multifamily, and Title I) for FHA's financial management systems that allocates funds to system development enhancement efforts. It is designed to eliminate outdated systems and to update systems that provide current, reliable data. FHA's overall systems and technology strategy includes:

- aligning technology investment with business plans,

- replacing, migrating, and enhancing existing systems,

- using data warehousing to improve data access and integration,

- focusing data cleanup teams where necessary,
- defining technology needs in conjunction with process reengineering, and
- following guidelines provided by OMB.

The goals of FHAMIS are to (1) eliminate data redundancies in single family insurance systems and maintain common databases where possible; (2) develop a new, unified single family insurance premium billing and reconciliation module to replace a number of old and disjointed premium systems; (3) develop a new single family property real estate-owned (REO) management system; (4) eliminate the reliance on costly contractor-run systems by developing similar systems in-house; (5) develop a new multifamily notes system; (6) create a new multifamily foreclosed property management system (dependent on the level of Secretary-held properties in inventory); (7) enhance the general ledger system; and (8) develop or enhance management information systems for both Multifamily and Single Family.

The year 2000 issue will also affect FHA's accounting and financial management systems. HUD is addressing the issue on a Department-wide level; it is accordingly not within the scope of this report. HUD has developed a departmental "Approach to Year 2000" and a detailed action plan.

During fiscal year 1996:

- FHA developed a plan and timetable for enhancing the subsidiary ledger accounting process. Selection of a general ledger is targeted for March 1997, with implementation effective October 1997. FHA plans to have a fully integrated financial management system installed for fiscal year 1998.
- FHA began developing an integrated multifamily system that will provide information to monitor the insured and Secretary-held portfolio better (including early warning and risk modules). The implementation plan for this system includes nationwide implementation of the Multifamily Data Warehouse currently underway.

  Further, the first phase of the multifamily early warning risk assessment system is under development.
- FHA developed a corrective action plan to provide information for Credit Reform compliance. The current systems have been enhanced to meet certain information requirements of credit reform and reporting. Systems will be fully updated to comply with the requirements in fiscal year 1998.
- The Single Family Premium Collection System for up-front premiums was developed and is currently in user acceptance testing. This system is scheduled to be implemented in fiscal year 1997.
- The Single Family Premium Collections System for periodic premiums is being developed and is scheduled for completion by the end of fiscal year 1997.

- Development of the Single Family Data Warehouse has begun. The warehouse pilot test for Phase I (Lender Monitoring and Post-Technical Review) has commenced using an end-user reporting/query tool, and additional equipment has been ordered and received. Implementation will begin in fiscal year 1997. The Single Family Data Warehouse Project Plan, supporting activities, and budget authority for 1997 through 2000, have been developed and approved.

- The Single Family Acquired Asset Management System (SAMS), the Debt Collection and Management System (DCAMS), and the Home Equity Conversion Mortgage System (HECMS) were all implemented.

KPMG's Assessment of Planned and Completed Actions

The goal of FHAMIS is to provide more comprehensive and modem financial management systems gradually. When implemented, the plan will provide an integrated set of systems to support financial and accounting functions. Progress is being made, and certain new systems have come on-line but much work needs to be done to implement the plan fully.

FHA's inability to develop or acquire information technology quickly will continue to impede its efforts to be a more efficient and effective housing credit provider and will downgrade FHA's relevance in the marketplace. Until new information technology is implemented and available, FHA will continue to collect data and develop information inefficiency. FHA must continue to pursue funding aggressively and place high priorities on systems development, modernization, and improvement, in accordance with its systems plans.

KPMG's Recommendations

As recommended in prior year, we continue to recommend that FHA further improve its financial management systems by aggressively monitoring and adhering to the timelines established in its action plans.

Additionally, we recommend that FHA:

- Continue efforts to purify data in its multifamily data warehouse to ensure that users have complete, accurate, and reliable information.

- Ensure users participate fully in systems design and development. Systems integration and development must be a fundamental component of all reengineering efforts.

KPMG'S CONCLUDING COMMENTS AND RECOMMENDATIONS FOR ADDITIONAL EFFICIENCY GAINS

Many of the issues discussed in this report are not new to FHA or to federal agencies in general. They are "legacy" issues that have compounded in their effects over many years. Many of these issues first appeared in FHA auditors' reports more than five years ago. Consistent with recent legislatively mandated government-wide reform initiatives, significant management efforts are being directed to improvements in these areas. However, progress toward correcting these weaknesses is slow, given the lack of resources, staffing shortages in critical areas, inadequate systems, and the fact that the issues are multifaceted, interrelated, and require diligent multiyear efforts to resolve. FHA management has responded to the challenge and has developed and implemented action plans that address each of the issues identified in this report. However, there are other significant barriers that prevent FHA from achieving its potential for correcting its problems and becoming a more proactive organization.

A significant barrier impeding FHA's progress, as broadly recognized in the HUD reinvention plan and FHA's business plan, is the challenge to change the culture, work environment, and work ethic within the organization. Many FHA employees are hard working and diligent and would be an asset to any team or organization. However, while it is inappropriate to generalize comments relating to the entire workforce, certain matters we have heard or observed bear repeating. In some cases, employees below the management level are not explicitly held accountable for their work and often do not appear to have specific work expectations or outcome measures to determine the quality of work performance. Some employees are "change averse" and suffer from low morale resulting from impending staff reductions. Some employees, therefore, view new initiatives with skepticism and may actually hinder FHA's progress. Some field division and segment supervisors operate in a "territorial" style and are hesitant to share resources or cooperate with other divisions outside of their control to proactively address operating issues or concerns.

We recommend that FHA develop a formal strategy to evaluate the cultural issues facing the organization and proceed on the task to change employee's attitudes; instill ownership interest in work performance; improve employee accountability measures; and encourage cooperation between lines of business and divisions. We recognize that statutes and administrative policies may inhibit success in this effort. Even without these barriers, it is a daunting task for any organization, but one that produces significant benefits.

FHA's reliance on contractors will increase as downsizing continues and its business activities become more automated. Effective use of contractor resources can improve efficiency and mitigate losses to FHA. However, HUD's current procurement process is not timely enough and thus limits the pace of progress. We understand that the procurement process is cumbersome due to the number of federal regulations that impact the contracting process. However, we recommend that HUD review its procurement policies and procedures to determine ways to eliminate any self-imposed redundancies to improve the efficiency of the process, while still adhering to the requirements of Federal Acquisition Regulations.

FHA's processes and systems have evolved over a long period of time and have changed to address specific issues or weaknesses in individual processes or systems without necessarily assessing macro level effects. FHA operates in a paper and process intensive environment with numerous non-integrated information systems. Prescriptive statutory mandates compound the complexity of many processes. FHA's 1994 reorganization effort began a focus on reengineering and streamlining its core operations. This effort needs to continue with a concerted effort toward making fundamental changes to all processes that affect all disciplines and user groups. This focus must determine the minimum processes necessary to achieve the desired results, maintain an adequate system of controls, and balance the costs of controls and their benefits. Working "smarter" is paramount to success in environments where resources are scarce. We recommend that reengineering teams be empowered to change processes and eliminate redundancies, unnecessary approvals, and extraneous paper. Teams should not only be from accounting, program, and field operations personnel, but input from industry, technology experts, the Inspector General, and General Counsel personnel, should be obtained as well.

In response to a prior year comment, during 1996 FHA updated and consolidated its internal control weakness corrective action plans into a single document that now serves as an efficient tracking tool for management. To further enhance this tool, we recommend that management define outcome measures to indicate when the results of a corrective action strategy have been achieved. Currently, management has identified dates for completion of activities, which is appropriate for monitoring when specified action has been taken. The suggested outcome measures would be used to evaluate when the anticipated results or benefits of the actions have been realized. As an example, management has set dates for the anticipated sales of Secretary-held mortgage notes. Success could be defined as maintaining the level of unsold notes at or below a specified unpaid principal balance. We believe that outcome measures can be identified for most of the corrective action plans, allowing management to measure when a desired goal has been achieved definitively.

FHA is changing for the better. We applaud management for its consistency in its efforts to make FHA relevant in, and responsive to, the marketplace. Although the process is challenging, the steady and diligent actions of past years are beginning to produce results.

FHA MUST CONTINUE ACTIONS TO QUICKLY RESOLVE SECRETARY-HELD MORTGAGE NOTES AND MINIMIZE ADDITIONAL MORTGAGE NOTE ASSIGNMENTS AND NOTE SERVICING RESPONSIBLITIES

Until 1994, Multifamily and Single Family Secretary-held mortgage note portfolios were growing rapidly. At that time, FHA owned almost 2,400 multifamily mortgage notes, with an outstanding principal balance of more than $7 billion, and approximately 90,000 single family mortgage notes, with an outstanding balance of approximately $4 billion. This mortgage note inventory was so large that it compromised FHA's capacity to perform its principal loss prevention functions.

In March 1994, FHA began addressing the Secretary-held inventory by initiating an aggressive program to sell its Secretary-held multifamily and single family mortgages. Under this program, subsidized and unsubsidized multifamily mortgage notes and single family mortgage notes are sold to the private sector in a series of asset sales. By the end of fiscal year 1998, FHA plans to have sold most of the current inventory and expects to use this strategy to keep note inventories at low levels.

FHA has made substantial progress in reducing the Secretary-held note inventory and has initiated efforts to manage future note assignments proactively. These successful efforts have resulted in the reclassification of this issue from a material weakness to a reportable condition.

Multifamily

Multifamily Action Plan: and Significant Activities to Improve Note Disposition/Resolution

To further reduce the number of multifamily notes in the Secretary-held portfolio and to minimize the number of multifamily notes assigned to FHA in the future, FHA plans to:

- *Continue selling performing and non-performing notes.* Since the inception of the note sales program in 1994, FHA has completed 9 note sales and plans to conduct at least 6 sales during 1997. FHA intends to sell substantially all the Secretary-held notes in its multifamily portfolio.

- *Implement Portfolio Reengineering Demonstration Program.* Approximately 8,500 FHA-insured multifamily projects were financed with 20-year Section 8 project-based rental subsidies from HUD. In fiscal year 1996, project-based Section 8 contracts began to expire. Without Section 8 rental assistance, many FHA-insured projects are at serious risk of default. Failure to act proactively would lead to an increase of mortgage assignments and cost the FHA insurance fund an estimated $11 billion.

  In 1996, FHA received authorization from Congress to proceed with a portfolio reengineering demonstration program on expiring Section 8 contracts for up to 15,000 housing units. As of the date of this report, 23 proposals have been accepted with conditions, 7 proposals have been fully approved, 36 proposals have been rejected, and 21 are pending loan committee review.

In 1997, Congress authorized another portfolio reengineering demonstration program impacting up to 50,000 housing units. Guidelines for participation in the 1997 program were published in the *Federal Register* on January 23, 1997. A Director of Housing has been assigned to implement the 1997 program and specific documents covering loan covenants, use agreements, and resident notices are currently under development.

- *Sell certain subsidized mortgage notes to public/private partnerships through must structures.* During 1996, FHA began negotiating direct sales of certain subsidized mortgage notes to housing finance agencies and other public entities. Three sales were scheduled for 1996, but negotiation difficulties prevented two. FHA is now developing a revised strategy to sell subsidized notes to public/private partnerships using a trust structure. The private entity will provide capital and asset management services and the public entity will provide regulatory oversight.

- *Seek authority to resume reflector sales of Section 221(g)(4) mortgages.* Lenders may assign performing 221(g)(4) multifamily mortgage loans to FHA during the 20th year of the mortgage loan in exchange for FHA debentures bearing current interest rates. Before its reflector sales authority expired in June 1996, FHA sold the beneficial interest in the mortgage and made a monthly interest subsidy payment to the buyer when market interest rates exceeded the interest rates on the mortgages, in lieu of accepting assignment after the 20th anniversary. This practice successfully limited additional multifamily mortgage note assignments and the related servicing requirements. Efforts are currently underway to seek Congressional extension of the 221(g)(4) auction authority during 1997.

- *Address disposition of Section 221(g)(4) mortgages.* FHA is developing a financial model to identify the best disposition strategy for Section 22l(g)(4) mortgages.

KPMG's Assessment of Planned and Completed Multifamily Actions

Sale	Number of Notes Sold	UPB of Notes Sold
Non-performing unsubsidized:		
West of Mississippi	152	$ 597 million
North Central	156	847 million
Non-performing subsidized:		
Missouri Housing Finance Agency	26	30 million
Partially Assisted	158	885 million
Total	492	$2,359 million

As shown above and in Exhibits 1 and 2, FHA completed four Secretary-held multifamily mortgage note sales during fiscal year 1996, reducing the unpaid principal balance by approximately $2.4 billion (41 percent) from the September 30, 1995, level to $3.3 billion as of September 30, 1996.

Exhibit 1

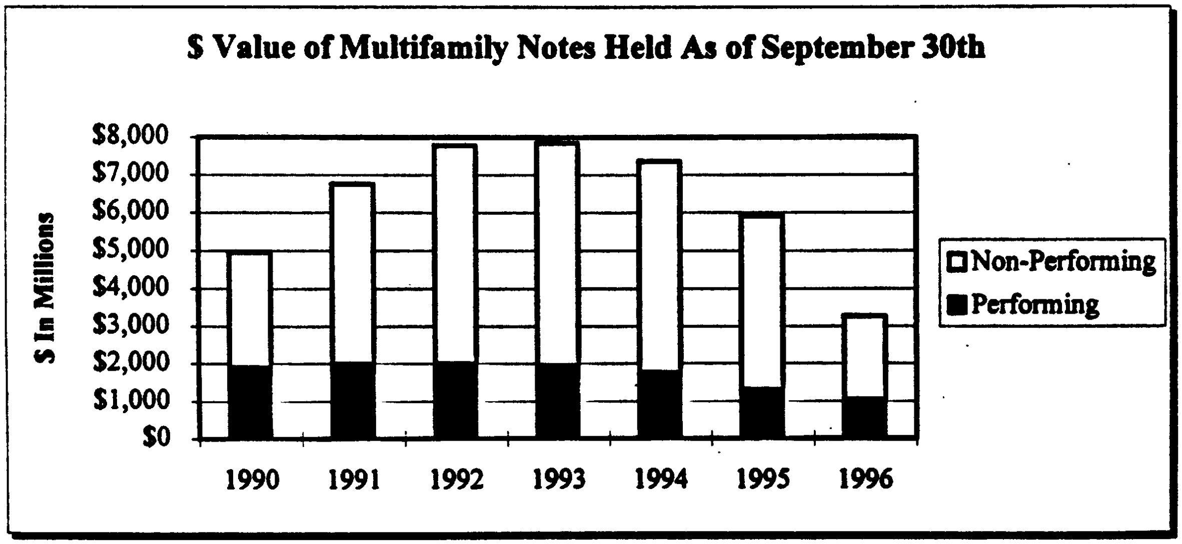
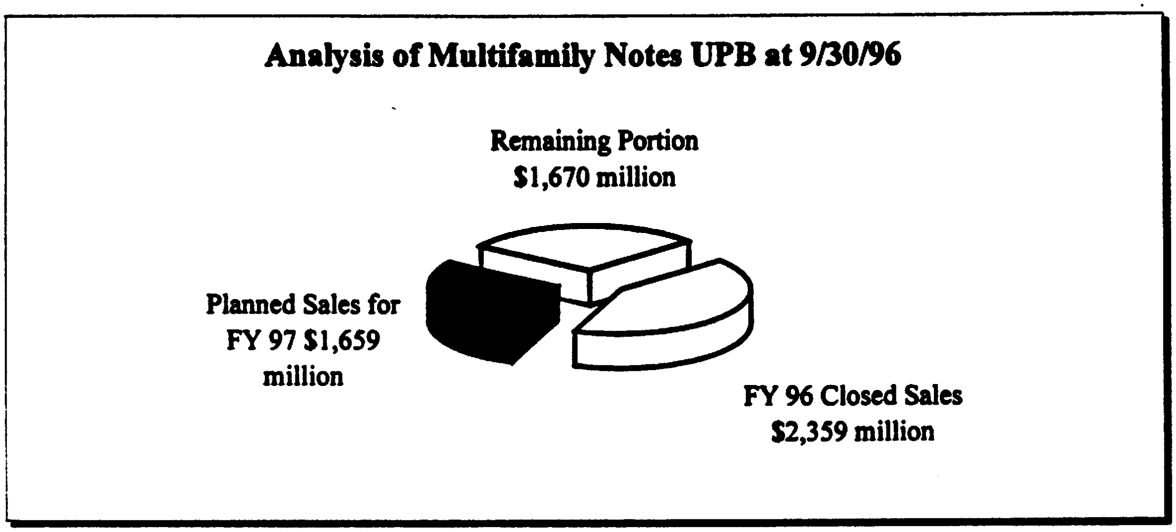


Exhibit 2



In December 1996, FHA sold 107 non-performing, unsubsidized mortgage notes, which further reduced the multifamily Secretary-held notes portfolio by $873 million. Additional inventory reductions estimated at $725 million are scheduled for fiscal year 1997.

In addition to managing the existing inventory, FHA has made progress at managing future multifamily mortgage note assignments through the portfolio reengineering demonstration program and the development of economic models to manage assignments associated with Section 221(g)(4) notes. The development of these two tools demonstrates Multifamily's commitment to managing future Secretary-held note inventory levels.

Despite the progress made on reducing the inventory, the total unpaid principal balance remains high. The notes remaining in inventory after 1997 may be harder to sell because they contain higher risk, partially assisted, and subsidized mortgages, which will require more complicated sales strategies or deep sales discounts.

KPMG's Multifamily Recommendations

- As recommended in prior year, we continue to recommend that FHA continue to reduce mortgage note inventory by:
  - ◊ holding scheduled mortgage note auctions,
  - ◊ developing a structure to sell subsidized notes to public or private partnerships, and
  - ◊ obtaining legislative authority to resume auction of section 221(g)(4) notes.

Additionally, we recommend that FHA:

- Aggressively pursue and encourage participation in portfolio reengineering efforts and continue to solicit Congressional support to extend the demonstration program beyond fiscal year 1997.

- Continue efforts to obtain legislative authority for portfolio reengineering beyond the approved demonstration program and resolve proposals to provide recommended tax relief to property owners affected by portfolio reengineering.

- Expand SWAT initiatives by forming regional teams by reallocating staff and incorporating SWAT activities into the matrix team concept used by field offices. Enforcement actions and necessary follow-up should be tracked to ensure timely completion.

Single Family

Single Family Action Plans and Significant Actions to Improve Note Disposition/Resolution

FHA has made significant progress in its efforts to resolve the operational inefficiencies resulting from its ownership, processing, and servicing of single family mortgage notes primarily through the note sales program. Servicing and managing the defaulted mortgage notes assigned to FHA requires considerable staff time, is not a part of FHA's principal line of business or mission (providing mortgage insurance and fostering homeownership opportunities), and diverts scarce resources from monitoring the insured portfolio and focusing on reducing claims to the FHA funds.

To further reduce the portfolio of Secretary-held single family mortgage notes and better service the remaining portfolio, FHA's Office of Single Family Housing plans to:

- *Continue sales of single family Secretary-held notes.* In March 1994, FHA began an aggressive program to sell substantially all of its Secretary-held single family mortgage notes. During fiscal year 1996, FHA completed three single family note sales and plans to complete three additional sales during fiscal year 1997.

- *Improve asset management for the remaining mortgage note portfolio by consolidating servicing activities.* As discussed in Appendix A, FHA plans to consolidate all remaining single family note servicing functions into the Atlanta Homeownership Center by the end of fiscal year 1998.

KPMG's Assessment of Planned and Completed Single Family Actions

During fiscal year 1996, FHA completed the following three Secretary-held single family mortgage note sales:

Sale	Number of Notes Sold	UPB of Notes Sold
1	12,981	$ 522 million
2	16,196	741 million
3	16,967	803 million
Total	46,144	$2,066 million

As shown above and in Exhibits 3 and 4, the three single family mortgage note sales completed during fiscal year 1996 reduced the single family note portfolio by approximately $2.07 billion (43 percent) from the September 30, 1995 level. During the second quarter of fiscal year 1997, FHA sold approximately 18,900 notes with an unpaid principal balance of approximately $1.13 billion to the private sector. Additional fiscal year 1997 sales are expected to total $1.42 billion.

Exhibit 3

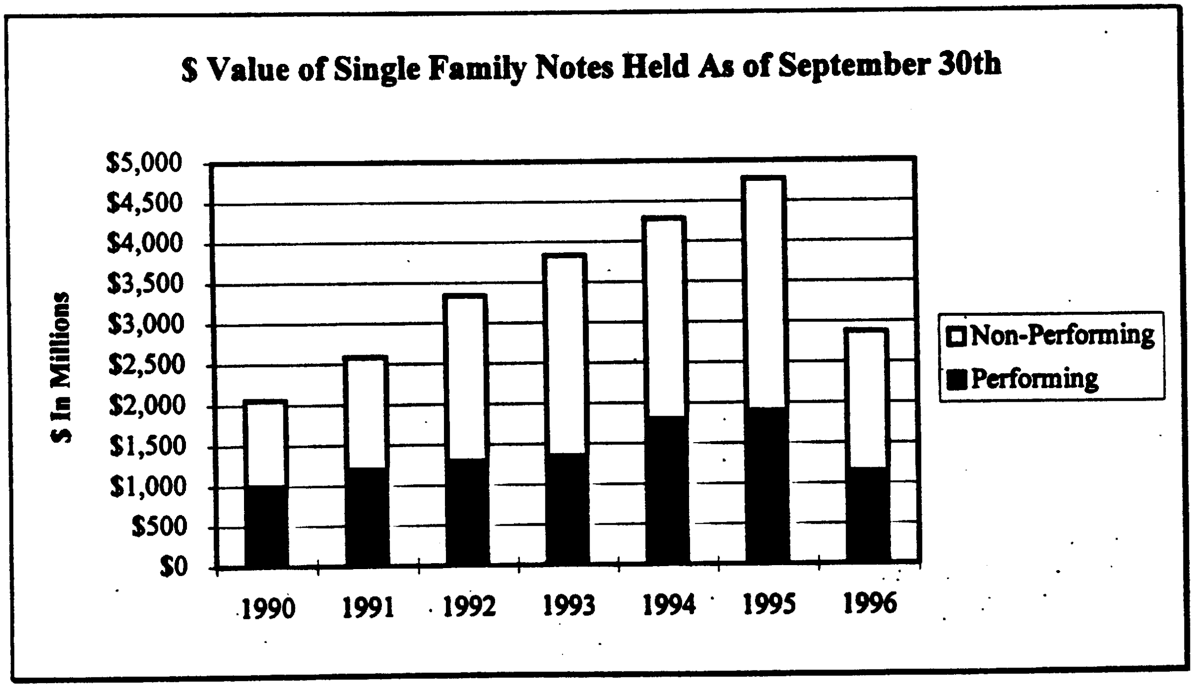
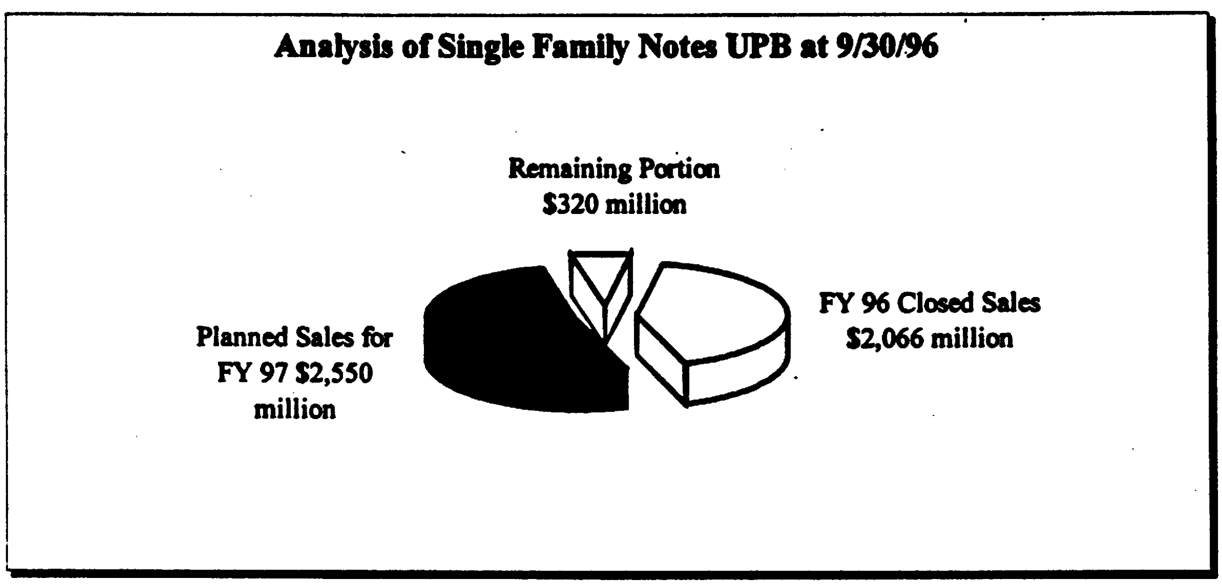


Exhibit 4



Progress is clearly being made in reducing the portfolio of Secretary-held single family mortgage notes, and concrete plans are in place to continue the notes sales program.

KPMG's Single Family Recommendations

In September 1996, the 1997 Appropriations Bill extended the legislation to eliminate eligibility for the assignment program for loans insured through fiscal year 1997. However, Congressional action is needed to ensure that the assignment program is terminated for fiscal year 1998 and beyond.

As recommended in the prior year, we continue to recommend that FHA continue its single family mortgage note sales schedule for 1997 and beyond. The challenge will be to sustain the focus on and commitment to the sales program while downsizing and consolidating.

We also recommend that FHA contract all servicing responsibilities for subordinate mortgages obtained as part of the partial claim process to an FHA-approved servicer.

FHA MUST SUFFICIENTLY MONITOR AND ACCOUNT FOR SINGLE FAMILY PROPERTY INVENTORY

FHA has control weaknesses in its single family property acquisition, management, and disposition functions. Factors contributing to this assessment include, but are not limited to:

- Instances of third-party abuse of (1) the 203(k) investor loan program, and (2) discounted sales to not-for-profit organizations through the Direct Sales Program.
- Delayed field office reconciliation of property sales proceeds.
- Inadequate field office oversight of property management, collection of sales proceeds, and other services provided by contractors.
- Input errors and data inaccuracies within the SAMS system and system conversion problems, have hindered its use as an efficient property management and accounting system.
- Delayed field office recognition and management of newly conveyed properties.
- Inadequate maintenance of case files resulting in missing deeds, titles, appraisals, and other pertinent ownership and valuation documentation.

These and other control weaknesses have (a) deceased FHA's ability to monitor, control, and report accurately on the Single Family Property Division's activities, (b) increased the risk of loss to FHA on the sales of its single family properties, (c) caused data input errors and incomplete data fields in the SAMS system, and (d) caused inefficiencies due to the need for expansive clean-up efforts to address data integrity problems.

Single Family Action Plans and Significant Action: to Improve Monitoring and Oversight of Single Family Property Inventory

FHA has taken the following actions to address these concerns and improve the monitoring and control over its single family property inventory:

- *Revise FHA's property disposition function.* As discussed in Appendix A, FHA is evaluating several alternatives to its current-process for disposing of its single family property inventory. In fiscal year 1997, FHA began a pilot program to contract out asset management and property disposition in three field offices. The results of this pilot will be used to evaluate the benefits and costs of contracting these services to the private sector.

- *Confirm ownership of aged inventory.* In August 1996, the Office of Single Family Housing began a nationwide effort to verify the ownership status of its aged inventory. This effort included reviewing the status of all single family properties owned for more than one year (approximately 2,300 properties at that time).

- *Conduct a review of business processes.* During 1997, FHA plans to hire a contractor to identify opportunities for streamlining the asset management and property disposition functions.

KPMG's Assessment of Planned and Completed Single Family Actions

Because FHA's pilot program is in the early stages and the business process review has not yet begun, possible benefits cannot yet be accurately predicted. As of December 30, 1996, over 300 properties have been identified as erroneously included in the September 30, 1996, inventory; however, further action to resolve these discrepancies has been delayed.

KPMG's Single Family Recommendations

If the pilot program supports outsourcing single family property management and disposition functions, we recommend that FHA implement the plan promptly and develop oversight tools and reports to effectively and efficiently monitor contractor(s).

Prior to a decision regarding which alternative to pursue, we recommend that FHA ensure adequate procedures to safeguard its assets and to report accurate and timely financial information and inventory changes are in place. To facilitate that goal, we recommend that FHA:

- Instruct field office personnel to verify the accuracy of data in the SAMS system, research possible data entry errors or omissions, and correct inaccurate information.

- Develop procedures that ensure data input by the field offices for properties yet to be brought into FHA's portfolio is accurate.

- Perform an in-depth application controls review of the SAMS system to ensure that data processing and reporting functions of the system are operating as designed and that the design is appropriate.

- Enhance current controls or develop procedures to better monitor (a) single family property sales to not-for-profit organizations and the related discounts granted on purchase prices, and (b) 203(k) investor loans.

- Effectively monitor contractors responsible for property security and maintenance to reduce the risk of loss while properties are owned by FHA.

FHA MUST PERFORM A COMPLETE REVIEW OF PROCESSING CONTROLS FOR ALL COMPUTER SYSTEMS AND PLACE MORE EMPRASIS ON COMPUTER SECURITY

There are control weaknesses in the overall and application level security in FHA's electronic data processing (EDP) environment. FHA management relies heavily on automated information systems to process the large volume of data required for a diverse insurance operation. FHA shares HUD's mainframe EDP systems, which include both Hitachi and Unisys mainframe computers. These systems process accounting data for functions including insurance processing, servicing, asset disposition, and sensitive cash receipt and disbursement transactions that require a secure control environment to prevent errors and unauthorized access.

FHA's Action Plans and Significant Action to Address Systems Security and KPMG's Assessment of Planned and Completed Actions

During fiscal year 1996, enhancements have been made for the overall security of the Unisys mainframe, however, further efforts are necessary to improve overall system security for both mainframes.

The security software for the Hitachi mainframe provides automatic or default resource protection, and critical programs and files have been defined for the security software, providing protection for these resources. Most application systems (all but approximately seven applications) have been placed under centralized security software control. However, a review of the Top Secret "ALL" record revealed that global inquiry access to sensitive system software resources had been granted.

Centralized security control over the Unisys mainframe on-line environment has not yet been fully implemented. Specifically, the system parameter that extends centralized security control to TIP files that control the on-line environment has not been activated.

In addition, it was found that sensitivity designations for positions that require access to sensitive data and applications are not consistent. The automated personnel security tracking system contains suspect data. Controls to ensure that background investigations are performed are weak.

Current security program management does not ensure that a consistent, centrally administered security program is in place. The Automated Data Processing (ADP) Security staff is removed from the organizational groups that implement application security. Security administrators with these organizational groups operate independently with little guidance or assistance from the ADP Security staff. HUD is enhancing many existing systems as part of its current information strategy plan. HUD is also replacing contractors for some of FHA's applications that do not reside on HUD's mainframes. As these actions occur, FHA plans to improve security and access controls. Until improvements are made, however, HUD and FHA remain vulnerable to unauthorized access. Finally, HUD is contracting for risk assessments for critical applications. The risk assessments will review and evaluate existing security controls.

KPMG’s Recommendation

As recommended in prior year, we continue to recommend that HUD:

- Proceed with plans to implement security software fully for both the Hitachi and Unisys mainframe environments and integrate application security with the mainframe security software.
- Remove unnecessary global privileges of the Top Secret “ALL” record on the Hitachi mainframe.
- Perform application controls reviews for all of the FHA systems. Reviews should cover all aspects of systems access and security controls and input and processing controls. Application certification continues to be inadequate because no documentation of testing is provided to the ADP security staff and issues outstanding from prior risk assessments have not been addressed. In addition, security plans for applications do not contain enough detail to protect resources.
- Adequately implement the application certification process and correct security weaknesses. Security plans for applications should be reviewed to ensure they protect FHA resources adequately.
- Additionally, we recommend that HUD perform background investigations for personnel who require access to sensitive data and applications.

COMPLIANCE WITH LAWS AND REGULATIONS

FHA is not in compliance with a data requirement of the Credit Reform Act of 1990 (Credit Reform).

The major objectives of the Federal Credit Reform Act of 1990 (Public Law 101-508) (Credit Reform) and the implementing Office of Management and Budget (OMB) guidance are to (1) more accurately measure the costs of federal credit programs; (2) place the cost of credit programs on a budgetary basis; (3) encourage delivery of benefits to beneficiaries; and (4) improve the allocation of resources among credit programs.

To facilitate the measurement and recognition of credit subsidies, losses, and program performance, Credit Reform requires each direct loan and loan guarantee to be categorized into a cohort and a risk category. A cohort (book of business) is defined as all direct loans obligated or loan guarantees committed by a program in the same year, even if the disbursements occur m later fiscal years or if the loan is modified. A risk category (projects with similar risk assessments) is a subdivision of a cohort for loans that are somewhat homogenous in cost, based on the known facts at the time of the obligation or commitment. Risk categories are used to estimate long-term costs, to control budget authority during the budget execution, and to make annual reestimates of costs.

FHA's single family periodic premiums systems cannot generate the required case-specific cash flow data required to reestimate its subsidies properly. Therefore, this data is allocated to cohorts and risk categories using estimates of cash flows (rather than actual cash flows). Credit Reform requires FHA to track the cash flows related to cohorts and risk categories at the case level. FHA maintains all other data used to calculate Credit Reform subsidies at the required case specific level.

In fiscal year 1996, the Office of the Comptroller developed and proposed a specific multiyear corrective action plan to comply with Credit Reform requirements. This proposed plan includes procedures for:

- Maintaining Credit Reform information at the case level;
- Enhancing information systems' capabilities to summarize actual information at the cohort and risk category level and compare performance to budget;
- Strengthening comparability and links between budget and actual data; and
- Improving tools and processes to evaluate portfolio performance at the Credit Reform cohort and risk category level.

If implemented according to the schedule proposed by FHA, systems enhancements to enable collection of case-specific data in the Single Family Premiums Collections System are expected to be completed by June 1997.

OMB enforces Credit Reform requirements and monitors FHA's credit activities. The proposed action plan was sent to OMB in 1996 for review and approval. Discussions with OMB are ongoing and resolution of this issue is expected during fiscal year 1997.

As recommended in prior year, we continue to recommend that FHA obtain concurrence from OMB as to the adequacy of its corrective action plan, and implement the plan.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	1996	1995
ASSETS:		
Fund Balances at the U.S. Treasury:		
Non-Interest Bearing	$5,608	$1,651
Interest Bearing	1,542	1,221
Total Fund Balances at the U.S. Treasury	7,150	2,872
Investments in U.S. Government Securities (Note 3)	7,661	6,605
Foreclosed Property Held for Sale, Net (Note 4)	1,162	1,220
Mortgage Notes Held for Sale, Net (Note 5)	3,971	6,107
Other Assets and Receivables	577	544
Total Assets	$20,521	$17,348
LIABILITIES AND GOVERNMENT EQUITY (DEFICIENCY):		
Claims Payable (Note 6)	$664	$443
Loss Reserves (Note 6)	12,986	11,065
Unearned Premiums (Note 7)	6,931	6,685
Debentures Issued to Claimants (Note 8)	82	87
Accounts Payable, Accrued Expenses, and Other Liabilities	424	544
Borrowings from the U.S. Treasury (Note 10)	3,123	1,647
Distributive Shares and Premium Refunds Payable	154	162
Total Liabilities	$24,364	$20,633
Government Equity (Deficiency) (Note 9):		
Mutual Funds Equity	$2,526	$1,871
Subsidized Funds Cumulative Losses	(21,043)	(19,769)
Appropriated Capital	14,674	14,613
Total Government Deficiency	$(3,843)	$(3,285)
Commitments and Contingencies (Notes 11 and 12)		
Total Liabilities and Government Deficiency	$20,521	$17,348

The notes to the financial statements are an integral part of this statement

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	1996	1995
REVENUES:		
Premiums:		
Annual P remiums	$1,084	$912
Earned Portion of Up-front Premiums	1,058	1,189
Total Premiums Earned	2,142	2,101
Interest Income	978	907
Other Revenues	70	142
Total Revenues	$3,190	$3,150
EXPENSES:		
Change in Loss Reserves	$1,921	$(1,185)
Provision for Losses on Properties Held for Sale	1,975	1,775
Provision for Losses on Mortgage Notes Held for Sale	(819)	(135)
Gain on Sale of Mortgage Notes Held for Sale	(187)	(531)
Salary and Administrative Expenses	683	644
Interest Expense	216	122
Other Expense	19	70
Total Expenses	3,808	760
(Deficiency) Excess of Revenues over Expenses	(618)	2,390
Government Deficiency, Beginning of Year	(3,285)	(5,528)
Distributive Shares Canceled	1	1
Distributive Shares Paid	(2)	(3)
Appropriations, Net	61	(145)
Government Deficiency, End of Year	(3,843)	(3,285)

The notes to the financial statements are an integral part of this statement

FEDERAL HOUSING ADMINISTRATION
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CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	Cumulative Results of Operations		Appropriated Capital		
	Mutual Funds Equity	Subsidized Funds Cumulative Losses	Pre-Fiscal 1992	Post-Fiscal 1992	Equity Total
Balance, September 30, 1994	$1,474	$(21, 760)	$14,628	$130	$(5,528)
Excess of Reviews over Expenses	399	1,991	0	0	2,390
Distributive Shares Declared	(3)	0	0	0	(3)
Distributive Shares Canceled	1	0	0	0	1
Credit Appropriations Received to Finance:					
Credit Subsidies on 1995 Mortgages	0	0	0	188	188
Administrative Expenses	0	0	0	198	198
Appropriations Returned to Treasury:					
Negative Subsidy:	-				
On insured 1995 mortgages	0	0	0	(132)	(132)
As a result of modifications due to asset sales	0	0	0	(399)	(399)
Balance, September 30, 1995	$1,871	$(19,769)	$14,628	$(15)	$(3,285)
(Deficiency) Excess of Reviews over Expenses	656	(1,274)	0	0	(618)
Distributive Shares Declared	(2)	0	0	0	(2)
Distributive Shares Canceled	1	0	0	0	1
Credit Appropriations Received to Finance:					
Credit Subsidies on 1996 Mortgages	0	0	0	152	152
Credit Subsidies as a Result of Asset Sales	0	0	0	533	533
Administrative Expenses	0	0	0	202	202
Appropriations Returned to Treasury:					
Negative Subsidy:					
On insured 1996 mortgages	0	0	0	(142)	(142)
As a result of re-estimates	0	0	0	(110)	(110)
As a result of modifications	0	0	0	(40)	(40)
As a result of modifications due to asset sales	0	0	0	(533)	(533)
As a result of budget recissions	0	0	0	(1)	(1)
Balance, September 30, 1996	$2,526	$(21,043)	$14,628	$46	$(3,843)

The notes to the financial statements are an integral part of this statement

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES:		
(Deficiency) Excess of Revenues over Expenses	$(618)	$2,390
Adjustments to Reconcile (Deficiency) Excess of Revenues to Net Cash Provided by Operating Activities:		
Provision for Losses on Properties and Mortgage Notes Held for Sale	1,156	1,640
Amortization of U.S. Government Securities	(57)	(39)
Gain on Sale of Mortgage Notes	(187)	(531)
Change in Assets and Liabilities:		
Claims Settlement Payments	(5,542)	(5,563)
Collections of Principal on Notes Acquired in Claims Settlement	232	302
Proceeds from Disposition of Assets Acquired in Claims Settlement	6,534	4,348
Increase in Other Assets	(33)	(38)
Increase (Decrease) in Claims Payable and Other Liabilities	93	(123)
Increase (Decrease) in Loss Reserves	1,921	(1,185)
Up-front Premiums Collected	1,722	1,203
Up-front Premiums Earned	(1,058)	(1,188)
Up-front Premiums Refunded	(418)	(237)
Net Cash Provided by Operating Activities	$3,745	$979
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of U.S. Government Securities	$(7,655)	$(6,787)
Maturity of U.S. Government Securities	6,657	5,903
Net Cash Used by Investing Activities	$(998)	$(884)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings from U.S. Treasury	$1,616	$885
Repayment of Borrowings from U.S. Treasury	(140)	(21)
Appropriated Capital	887	386
Return of Appropriated Capital	(826)	(531)
Issuance of Debentures to Claimants	65	41
Payment of Debentures to Claimants	(70)	(66)
Participant Distributive Shares Canceled	1	1
Participant Distributive Shares Declared	(2)	(3)
Net Cash Provided by Financing Activities	$1,531	$692
Net Increase in Cash and Cash Equivalents	$4,278	$787
Cash and Cash Equivalents, Beginning of Year	2,872	2,085
Cash and Cash Equivalents, End of Year	$7,150	$2,872

The notes to the financial statements are an integral part of this statement

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 1996 AND 1995

Note l. Description of Entity and Significant Accounting Policies

Entity and Mission

The Federal Housing Administration (FHA) was established in 1934 and became a wholly-owned government corporation in 1948 subject to the Government Corporation Control Act, as amended. While FHA was established as a separate federal entity, it was subsequently merged into the Department of Housing and Urban Development (HUD) when that department was created in 1965. FHA does riot maintain a separate staff or facilities; its operations are conducted, along with other Housing activities, by HUD organizations. FHA is beaded by HUD's Assistant Secretary for Housing/Federal Housing Commissioner, who reports to the Secretary of HUD. FHA's activities are included in the Housing section of the HUD budget.

FHA administers some 40 active mortgage insurance programs, thereby making mortgage financing more accessible to the home-buying public. Its programs are designed primarily to serve first-time home buyers and provide affordable multifamily housing.

The FHA programs are organized into four major activities: (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest activity, provides basic single family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon nonclaim termination of their mortgages, share surplus premiums paid into the MMI Fund that are not required for operating expenses and losses or to build equity; (2) the Cooperative Management Housing Insurance Fund (CMHI), also a mutual fund, provides mortgage insurance for management-type cooperatives; (3) the General Insurance Fund (GI) provides for a large number of specialized mortgage insurance programs, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals; and (4) the Special Risk Insurance Fund (SRI) provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

The MMI and CMHI Funds are required to be operated in accordance with "sound actuarial and accounting practice"; therefore, borrowers are charged a premium that is designed to cover default losses and administrative expenses, and thus provide equity. These Funds are not to be dependent upon appropriations to sustain operations. The GI and SRI Funds, however, are not to be self-sustaining, and as a result, are dependent on appropriations from Congress.

Basis of Accounting

The Consolidated Statements of Financial Position, Statements of Operations, Statements of Changes in Government Equity (Deficiency), and Statements of Cash Flows have been prepared in accordance with generally accepted accounting principles. All material interfund transactions and balances have been eliminated.

Fund Balances at the U.S. Treasury

Prior to the Federal Credit Reform Act of 1990 (Credit Reform) which is discussed in Note 10, cash generated from insurance endorsements, and not needed for short-term operating purposes was invested in nonmarketable U.S. Government securities with terms similar to securities that are publicly marketed. Substantially all of FHA's cash receipts and disbursements are processed by the U.S. Treasury through either interest or noninterest-bearing accounts. All cash generated from insurance endorsed on or after October 1, 1991, is deposited in an interest-bearing account in accordance with Credit Reform. The account earns interest similar to that paid on U.S. Treasury securities with maturity intervals of ten years or longer. The noninterest-bearing account is comprised of uninvested cash emanating from insurance endorsed prior to October 1, 1991 (pre-fiscal year 1992 credits).

For purposes of the Consolidated Statements of Cash Flows, interest bearing and noninterest bearing funds at the U.S. Treasury are presented ass cash and cash equivalents.

Investments in U.S. Government Securities

FHA categorizes its investment portfolio according to its ability and intent to hold the investments to maturity. Since FHA management believes it has both the ability and intent to hold securities to maturity, investments in U.S. Government securities are reported at amortized cost (see Note 3). Amortization of premiums and discounts are recognized on a straight-line basis throughout the year.

Mortgage Notes Held for Sale

Prior to April 1996, under certain conditions prescribed by law, FHA would take assignment of insured single family mortgages which were in default rather than acquire the related properties through foreclosure. Single family mortgages were assigned to FHA when the mortgagor defaulted due to certain “temporary hardship” conditions beyond the control of the mortgagor and when, in FHA management’s judgment, the mortgage could be brought current in the future.

During 1996, Congress mandated that FHA discontinue the single family assignment program and develop and implement a loss mitigation program to reduce claims and related costs. FHA, however, continues to take single family assignments on those defaulted mortgage notes that were in process at the time the assignment program was terminated.

Multifamily mortgages are assigned when lenders file mortgage insurance claims to FHA for defaulted notes. In addition, multifamily and single family performing notes insured pursuant to Section 22l(g)(4) of the National Housing Act may be assigned automatically to FHA at a point (see Note 12).

Mortgage notes held for sale are recorded at the lower of cost or fair value. Fair value is estimated based on prevailing market interest rates at the time of mortgage assignment. When fair market value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the mortgages. Interest is recognized as income when earned. However, when full collection of principal is considered doubtful, the accrual of interest income is suspended, and receipts (both interest and principal) are recorded as collections of principal. Mortgage notes held for sale are reported net of the allowance for loss and any unamortized discount.

Foreclosed Property Held for Sale

Foreclosed property held far sale is obtained in claims settlement. It is report net of an allowance for loss which is established to reduce the property carrying value to its value less cost of sales.

Loss Reserves

Loss reserves in the MMI Fund are provided for estimated losses incurred by FHA to pay claims on insured mortgages when defaults have taken place, but where claims have not yet been filed. Claims loss reserves in the GI, SRI, and CMHI Funds are recorded when defaults are considered probable but have probable but have not yet been reported to FHA (see Note 6).

Premiums and Unearned Revenue

Premiums charged by FHA far single fami1y mortgage insurance provided by its MMI Fund include up-front and risk-based annual premiums. The risk-based annual premiums are recognized on a straight-line basis throughout the year. Up-front premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur.

FHA’s other activities, including most of those conducted through the GI and SRI Funds, charge periodic premiums over the mortgage insurance term. Premiums on annual installment policies are recognized on a straight-line basis throughout the year.

Appropriations and Funds Received from Other HUD Programs

The GI and SRI Funds were not designed to be self-sustaining. As a result, the National Housing Act, as amended, provides for appropriations from Congress to cover the operations of these Funds.

The Credit Reform Act of 1990 changed the method by which FHA receives appropriations from Congress. Beginning in fiscal year 1992, appropriations to the GI and SRI Funds are made at the beginning of each fiscal year to cover estimated losses on loans to be insured during that year. The revised appropriation structure also authorizes permanent indefinite appropriation authority to finance the cash requirements of operations resulting from endorsements in years prior to fiscal year 1992.

Funds received from other HUD programs, such as interest subsidies and rent supplements, are recorded as revenue when services are rendered.

Distributive Shares

As mutual funds, the MMI and CMHI Funds distribute excess revenues to mortgagors at the discretion of the Sectary of HUD. Such distributions are determined based on the MMI and CMHI Funds' financial positions and their projected revenues and costs. In November 1990, Congress passed the National Affordable Housing Act, which effectively suspended payment of distributive shares from the MMI Fund, other than those already declared by the Secretary, until the Fund meets certain equity requirements (see Note 9). Although the equity requirements were met at September 30, 1996 and 1995, no distributive shares were declared in those years. The National Affordable Housing Act does not affect the distributions from the CMHI Fund.

Fair Values of Financial Instruments

The fair value of a financial instrument is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties.

The fair value and amortized costs of FHA's Investments in U.S. Government Securities (see Note 3), Mortgage Notes Held for Sale (see Note 5), and Debentures Issued to Claimants (see Note 8), are disclosed in the related footnotes.

FHA's loan guarantees are financial instruments. The fair value of FHA's loan guarantees are based on discounted cash flow calculations, considering historical claim and loss experience data, adjusted for judgements concerning economic factors. The recorded Loss Reserves for the GI and SRI Funds represent the estimated fair values of FHA's liabilities for this insurance. Actual results may differ, perhaps significantly, from the estimates.

The MMI Fund establishes loan guarantees with the receipt of up-front premiums and continues to receive monthly premiums. The Fund currently holds $11.5 billion in cash and investments that are available to offset the liabilities for the loan guarantees discussed below.

The carrying value of the MMI Fund loan guarantees is a combined liability of $9.0 billion, consisting of liabilities for losses and loss adjustments expenses of $2.2 billion and unearned premiums of $6.8 billion. Based on discounted future cash flows, the fair value of the MMI Fund loan guarantees is estimated to be a liability of $2.3 billion. Both the recorded liabilities and the estimated fair value of the loan guarantees exclude substantial assets FHA has already received in exchange for these guarantees.

Given the assets on hand and future cash flows, as indicted in the discussion of the capital ratio, the MMI Fund is projected to remain financially self-sufficient. The discussion of the capital ratio and economic net worth of the MMI Fund are disclosed in Note 9.

The estimated fair value of FHA's Borrowings from the U.S. Treasury approximate their carrying value because the weighted average of the stated interest rates at September 30, 1996 and 1995, approximated the U.S. Treasury borrowing rates at those dates.

The carrying values for all other financial statement items (Fund Balances at the U.S. Treasury; Other Assets and Receivables; Claims Payable; Accounts Payable, Accrued Expenses, and Other Liabilities; and Distributive Shares and Premium Refunds Payable) approximate the estimated fair values for those instruments, due to their short-term nature.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results will invariably differ from those estimates.

Reclassifications

Reclassifications were made to the 1995 financial statements to conform with the presentation used in 1996. The changes in classifications have no effect on previously reported net income.

Note 2. Intragovernmental Financial Activities

FHA is not a separate federal entity. It is an integral part of the operations of HUD and is, therefore, subject to the financial decisions and management controls of the Secretary of HUD. Similarly, FHA is also subject to the directives and financial decisions of the Office of Management and Budget (OMB).

Rent Supplements and Interest Subsidies

HUD provides rent supplements and interest subsidies to lenders on behalf of certain eligible mortgagors and/or occupants of single and multifamily properties which FHA insures, or for which it holds the mortgage. In cases where FHA holds the mortgage, FHA receives any benefit payments directly from HUD on behalf of those individuals who are repaying the loan or occupying the property.

During fiscal years 1996 and 1995, FHA received the following interest subsidy and rent supplement payments from HUD (dollars in millions):

Description	1996	1995
Multifamily Notes-Interest Subsidy	$36	$36
Rental Supplements for Low And Very Low Income Families	9	16
Total	$45	$52

Amounts receivable from HUD as of September 30, 1996 and 1995, for the above assistance programs are not material.

To the extent FHA-insured mortgagors receive rent supplement payments and/or interest subsidy, FHA benefits indirectly since these assistance payments will reduce the risk of the mortgagors failing to repay the FHA-insured loans.

With respect to rent supplement payments, it is estimated that during fiscal year 1996, approximately 54% of project with FHA-insured loans (accounting for 35% of the insured unpaid principal balance) of GI/SRI Funds received rent supplement payments from HUD. Such payments accounted for approximately 58% of the aggregate rent revenue received by these project.

With respect to interest subsidy payments, lenders for approximately 21% of insured mortgages (accounting for 10% of the insured unpaid principal balance) of the GI/SRI Funds receive such subsidies under the Section 236 program. During fiscal year 1996, interest subsidy payments amounted to approximately 63% of the aggregate mortgage payments on these insured mortgages.

Administrative Expenses Reimbursed to HUD

HUD is reimbursed by FHA for personnel, property and equipment, and administrative services costs, since virtually all FHA operations are performed by HUD personnel. For fiscal years 1996 and 1995, the reimbursements totaled $544 million and $506 million, respectively. These annual reimbursements are budgeted amounts approved by Congress each fiscal year. They are based on the estimated staff levels used to carry out FHA activities, not the time actually worked by HUD personnel on these activities.

All permanent employees participate in the contributory Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS) which became effective January 1, 1987. Temporary employees and employees participating in FERS are covered under the Federal Insurance Contributions Act (FICA). FHA reimburses HUD for matching contributions to the CSRS, FERS and FICA. FHA also reimbursed HUD for matching contributions to the Thrift Savings Plan component of FERS up to 5% of basic pay but has no liability for future payments to employees under these programs. In addition, all permanent employees are eligible to participate in the contributory Federal Employees Health Benefit Program (FEHBP) and may continue to participate after retirement. Furthermore, FHA reimburses HUD for matching contributions to the FEHBP for active employees but is not responsible for contributions on behalf of retirees.

Note 3. Investments in U.S. Government Securities

FHA's investment portfolio consists of non-marketable U.S. Government securities. FHA categorizes its investment portfolio according to its intent and ability to hold its investments. FHA management has demonstrated, through both policy and performance, its ability to hold its investments to maturity. Accordingly, investments are reported at amortized cost.

The amortized cost and the fair value of investments were as follows at September 30, 1996 and 1995 (dollars in millions):

Description	1996	1995
Amortized Cost	$7,661	$6,605
Unrealized Gains	205	314
Unrealized Losses	(79)	(8)
Fair Value	$7,787	$6,911

Investment income was $542 million and $411 million for the years ended September 30, 1996 and 1995, respectively, and is included in interest income on the Consolidated Statements of Operations. Expenses relating to these investments are not significant.

The amortized cost and the fair value of investments at September 30, 1996, by maturity period, were as follows (dollars in millions):

Maturity	Amortized Cost	Fair Value
One Year or Less	$1,697	$1,712
After One Year through Five	2,494	2,516
After Five Years Through Ten	2,431	2,402
After Ten Years Through Fifteen	986	1,095
After Fifteen Years	53	62
Total Investments	$7,661	$7,787

As of September 30, 1995, investments were as follows (dollars in millions):

Maturity	Amortized Cost	Fair Value
One Year or Less	$1,027	$1,031
After One Year through Five	2,874	2,950
After Five Years Through Ten	1,666	1,730
After Ten Years Through Fifteen	894	1,005
After Fifteen Years	144	195
Total Investments	$6,605	$6,911

FHA's interest-bearing account at the U.S. Treasury earns interest at the rates established by Treasury for Credit Reform accounts. The rates are based on the maturity of mortgage loans FHA insures. Accordingly, FHA earns interest based on a maturity interval of ten years and longer and earned interest at an average rate of 7% for fiscal year 1996 and 7.1% for fiscal year 1995. There are no penalties if FHA must use the cash in this account over a shorter period to finance credit losses from post-fiscal year 1991 insurance endorsements.

Interest income on interest-bearing accounts at the U.S. Treasury was $163 million and $151 million for the years ended September 30, 1996 and 1995, respectively.

Note 4. Foreclosed Property Held for Sale

Foreclosed property held for sale was comprised of the following classes of property at September 30, 1996 and 1995 (dollars in millions):

Description	1996	1995
Single Family Homes	$1,860	$1,806
Multifamily Properties	490	535
Total Properties	2,350	2,341
Allowance for Losses	(1,188)	(1,121)
Property, Net	$1,162	$1,220

Changes in the allowance for losses on property for the years ended September 30, 1996 and 1995, were as follows (dollars in millions):

Description	1995	1996
Balance, Beginning of Year	$1,121	$1,368
Provision for Losses Charged to Operations	1,975	1,775
Realized Losses on Property Disposal	(1,908)	(2,022)
Balance, End of Year	$1,188	$1,121

Realized losses on the disposal of foreclosed property, for each fund, for the years ended September 30, 1996 and 1995, were as follows (dollars in millions):

Fund	1996	1995
MMI	$1,355	$1,415
CMHI	0	0
GI	502	506
SRI	51	101
Total	$1,908	$2,022

Note 5. Mortgage Notes Held for Sale

Mortgage notes held for sale was comprised of the following classes of notes at September 30, 1996 and 1995 (dollars in millions):

Description	1996	1995
Performing		
Single Family	$1,158	$2,002
Multifamily	1,049	1,307
Title I	18	19
Total Performing	2,225	3,328
Nonperforming		
Single Family	1,865	2,772
Multifamily	2,210	4,609
Title I	279	361
Total Nonperforming	4,351	7,742
Total Mortgages	6,576	11,070
Unearned Discount	(247)	(303)
Allowance for Losses	(2,358)	(4,660)
Total Unearned Discount & Allowance for Losses	(2,605)	(4,963)
Total Mortgages, Net	$3,971	$6,107

Most of the mortgage notes held were assigned to FHA when mortgagors defaulted. Lenders holding defaulted multifamily mortgages may make mortgage insurance claims by assigning the mortgages to FHA. In addition, FHA would take assignment of single family notes when defaults resulted from temporary hardship conditions. However, during 1996, congress mandated that FHA discontinue the single family assignment program and develop and implement a loss mitigation program to reduce defaults and related costs. FHA continues to take assignment on those defaulted mortgage notes that were in process a the time the assignment program was terminated. In addition, performing single family and multifamily notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point (see Note 12).

Mortgages acquired at interest rates below the market rate are recorded at a discount. This discount reduces the value of the mortgages such that the effective interest rate approximates the market interest rate in the year of acquisition. The weighted average nominal interest rates for all mortgages are 9.29% on single family notes; 7.61% on multifamily notes; and 6.02% on Title I notes. The effective interest rates at September 30, 1996, after discounting are 9.36% on single family notes; 8.56% on multifamily notes; and 6.02% on Title I notes. Mortgages which are considered current but which are under forbearance agreements comprise approximately $1.1 billion of the entire single family portfolio. The amount of multifamily notes under workout agreements is $504 million.

Interest income on performing mortgage notes was $271 million and $343 million for the years ended September 30, 1996 and 1995, respectively. If interest on the nonperforming mortgages had been accrued, that interest income would have approximated $491 million for the year ended September 30, 1996, and $680 million for the year ended September 30, 1995.

Changes in the allowance for losses and unearned discounts on mortgage notes held for sale for the years ended September 30, 1996 and 1995, were as follows (dollars in millions):

Description	1996	1995
Balance, Beginning of Year	$4,963	$5,915
Provision for Losses charged to Operations	(819)	(135)
Realized Losses & Write Offs, Net of Recoveries	(1,539)	(817)
Balance, End of Year	$2,605	$4,963

Escrow funds held by FHA were $238 million as of September 30, 1996, and $271 million as of September 30, 1995. Escrow advances for mortgage notes held, net of allowance for loss, were $69 million and $83 million as of September 30, 1996 and 1995, respectively.

FHA foreclosure costs during fiscal years 1996 and 1995 totaled $550 million and $284 million, respectively. The unpaid principal balance on pending foreclosures was $674 million for fiscal year 1996 and $1.1 billion for fiscal year 1995.

In fiscal year 1995, FHA sold 526 of its performing and nonperforming multifamily mortgage notes for $1.1 billion which resulted in a gain of $531 million after considering the related loss allowance, unearned discount, and cost of sales.

During fiscal year 1996, FHA conducted ten mortgage note sales, the more significant of which are summarized below (dollars in millions):

	No. of Sales	Mortgage Notes Sold	Gross Sales Proceeds	Gain on Sales
Single Family	3	46,144	$1,740	$ 78
Multi-family	5	493	1,637	109

In fiscal year 1996, a multifamily mortgage notes sale was accomplished through use of an asset securitization structure. Mortgages were pooled and sold to a Grantor Trust resulting in sales proceeds of $645 million and a 30% equity interest in subordinate class B trust certificates valued at $60 million. FHA has no guarantees resulting from this transaction and risk of loss is limited to the trust certificates held. The $60 million equity interest is included in Other Assets and Receivables line in the Consolidated Statements of Financial Position.

Subsequent to September 30, 1996, FHA sold 107 performing and nonperforming multifamily mortgage notes with an unpaid principal balance of $873 million. Also, in January 1997, FHA entered into an agreement to sell 18,879 single family mortgage notes with an unpaid principal balance of $1.1 billion.

Note 6. Loss Reserves and Claims Payable

Loss reserves for claims and reserves for loss adjustment expenses (LAE) for processing claims for single family, multifamily, and Title I mortgages, were as follows as of September 30, 1996 and 1995 (dollars in millions):

Fund	Claims Loss Reserve	LAE Reserve	1996 Total	1995 Total
MMI	$ 2,132	$103	$ 2,235	$ 2,169
CMHI	6	0	6	6
GI	9,198	228	9,426	7,800
SRI	1,292	27	1,319	1,090
Total	$12,628	$358	$12,986	$11,065

The MMI fund records a loss reserve for claims to provide for estimated losses incurred by FHA to pay claims on insured mortgages where defaults have taken place but where claims have not yet been filed. The reserve is estimated based on historical claim and loss experience data, adjusted for judgements concerning current economic factors.

Discounted loss reserves for claims in the GI and SRI Funds are recorded when loan defaults are considered probably but have not yet been reported as such to FHA. Management has conducted special projects to review the credit risk of projects with insured mortgages in its insured multifamily portfolio and to calculate a loss reserve as of September 30, 1996 and 1995. Based on the results of the 1996 review, multifamily loss reserves increased by approximately $1.9 billion through a charge to fiscal year 1996 operations. The increase in loss reserves for the GI and SRI Funds is primarily attributable to an increase in expected losses on projects receiving Section 8 subsidy payments reduced by an increase in expected recoveries upon ultimate resolution of default claims. The multifamily loss reserves recorded at September 30, 1996, for the GI and SRI Funds, including loss adjustment expense amounted to $8.9 billion and $1.3 billion, respectively.

In the aggregate, loss reserves have been established for approximately 20.6% of the multifamily unpaid principal balance at September 30, 1996.

Management believes that this level of reserves is necessary because multifamily insurance claim payments are expected to increase significantly in subsequent years. This assessment is based upon management's consideration of: (1) the current financial and operational status of the multifamily projects in the portfolio; (2) the anticipated availability of cash inflows in the form of rent or rent assistance, particularly Section 8 subsidy programs, for this projects (see Note 12).

Aggregate premiums generated by the GI and SRI Funds' various programs will not be sufficient to cover losses in the Funds, or to sustain their operations. The severity of the losses in these funds and the insufficiency of their premiums leave the Funds dependent on budget appropriations to sustain their operations as originally intended under statutes. While activity in the GI fund programs continues to be significant, activity in all of the SRI Fund's major programs has decreased substantially in recent years.

The LAE reserve is provided for estimated administrative expenses of settling potential claims included in the claims loss reserve. Claims payable represent claims established by FHA but remaining unpaid at year end.

The following table provides a reconciliation of beginning and ending liabilities for claims payable and loss reserves and LAE as of September 30, 1996 and 1995 (dollars in millions):

Description	**1996**	**1995**
Balances, Beginning of Year		
Claims Payable	$ 443	$ 484
Loss Reserves and LAE	11,065	12,250
Total Balances, Beginning of Year	11,508	12,734
Provision for Current Year	693	704
Provision for Prior Years	3,472	281
Total Provisions	4,165	985
Payments Related to Current Year	(761)	(835)
Payments Related to Prior Year	(4,781)	(4,728)
Total Claim Settlement Payments	(5,542)	(5,563)
Less: Estimated Recoveries	3,519	3,352
Net Payments	(2,023)	(2,211)
Balances, End of Year		
Claims Payable	664	443
Loss Reserves and LAE	12,986	11,065
Total Balances, End of Year	$13,650	$11,508

Note 7. Unearned Premiums

The following presents the activity in unearned premiums during 1995 and 1996 (dollars in millions):

	MMI	CMHI	GI	SRI	TOTAL
Balance, September 30, 1994	$6,774	$1	$115	$17	$6,907
Premiums Collected	915	2	251	35	1,203
Premiums Earned	(910)	(2)	(241)	(35)	(1,188)
Premiums Refunded	(230)	0	(7)	0	(237)
Balance, September 30, 1995	$6,549	$1	$118	$17	$6,685
Premiums Collected	1,417	1	269	35	1,722
Premiums Earned	(768)	(1)	(254)	(35)	(1,058)
Premiums Refunded	(410)	0	(8)	0	(418)
Balance, September 30, 1996	$6,788	$1	$125	$17	$6,931

Note 8. Debentures Issues to Claimants

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by Treasury. Interest rates related to the outstanding debentures range from 5.375% to 12.875%. They may be redeemed to lenders prior to maturity to pay mortgage insurance premiums to FHA or may be called with the approval of the Secretary of the Treasury.

Debentures outstanding at September 30, 1996 and 1995, based on original maturity dates, were as follows (dollars in millions):

Due:	Par Value 1996	Par Value 1995
One Year or Less	$ 1	$ 3
After One Year through Five	0	18
After Five Years Through Ten	3	9
After Ten Years Through Fifteen	13	23
After Fifteen Years	65	34
Total	$82	$87

The fair value of debentures outstanding at September 30, 1996, based on scheduled maturity dates, was $104 million at September 30, 1996 and $108 million at September 30, 1995. On January 1, 1997, the Federal Housing Commissioner called all callable debentures outstanding as of September 30, 1996. The par value and fair value of the called debentures at the call date was $66 million. The remaining $16 million in debentures which are not callable bear interest at rates ranging from 10.375% to 12.875%. The fair value of the debentures outstanding at September 30, 1996, based on the January 1, 1997, call date, or the original maturity date where applicable, was approximately $87 million as of September 30, 1996.

Interest expense for debentures during the year ended September 30, 1996 and 1995, was $18 million and $15 million, respectively. Interest is payable on January 1 and July 1 of each year.

Note 9. Government Equity (Deficiency)

As mutual insurance funds, the MMI and CMHI Funds generate surplus which is held in equity accounts. Such equity is either held to meet capital ratio requirements or distributed to eligible policyholders.

Under the National Affordable Housing Act of 1990 (Affordable Housing Act), the MMI Fund must attain a capital ratio of 2.0% within ten years of enactment. The Affordable Housing Act defines the capital ratio as the ratio of the economic net worth of the MMI Fund to unamortized insurance in force.

Unamortized insurance in force is defined by the Affordable Housing Act to be the remaining obligation on outstanding mortgages and is, therefore, the same as the MMI Fund's insurance in force. The economic net worth, as defined by the Affordable Housing Act, is the current cash available to the MMI Fund, plus the present value of all future cash inflows and outflows expected to result from the outstanding mortgages insured by the MMI Fund.

The MMI Fund's equity determined in accordance with generally accepted accounting principles (GAAP), because GAAP-determined equity is not based on the net present value of future cash flows.

Since fiscal year 1989, FHA has commissioned independent annual studies of the actuarial soundness of the MMI Fund. These studies may be used, in part, to estimate the economic net worth of the MMI Fund. The results of the most recent study indicate that the MMI Fund has an economic value of approximately $9.4 billion and a capital ratio of 2.54% as of September 30, 1996, based on unamortized insurance in force.

Whereas the Affordable Housing Act defines unamortized insurance in force as "the remaining obligation on outstanding mortgages", this definition is more commonly understood to be the amortized insurance in force. Use of amortized insurance in force increases the capital ratio as of September 30, 1996, to 2.71%.

Standing legislation provides for appropriations to cover cumulative losses in the GI and SRI Funds and, as discussed in Note 10, any upward adjustments to subsidy re-estimates. These appropriations are available when needed, with the concurrence of OMB.

Note 10. Credit Program Funding

Credit Reform

FHA's activities are subject to the Federal Credit Reform Act of 1990 ("Credit Reform"), which became effective on October 1, 1991. A primary purpose of Credit Reform is to more accurately measure the "subsidy" costs of Federal credit programs. Subsidy costs generally comprise the present value of estimated disbursements for costs associated with mortgage defaults, net of the present value of estimated collections for insurance premiums and claim recoveries.

For mortgages insured on or after October 1, 1991, up-front appropriations are required to finance credit subsidy costs. Appropriations to finance subsidy costs in the GI/SRI Funds were $152 million and $188 million in fiscal year 1996 and fiscal year 1995, respectively. FHA's MMI Fund has not received credit subsidy appropriations because the premiums charged are estimated to exceed associated costs.

For mortgages insured prior to October 1, 1991, permanent indefinite appropriations are available to finance costs associated with such mortgages to the extent premiums, recoveries and financing are insufficient to do so. There were not appropriations drawn for pre-Credit Reform mortgages for fiscal years ended September 30, 1996 and 1995.

Administrative Expenses

Administrative expenses of the GI/SRI Funds are funded by annual appropriations which are separate from subsidy appropriations and are not determined on a present value basis. The GI/SRI Funds administrative costs were $202 million and $198 million for fiscal years 1996 and 1995, respectively.

The MMI Fund administrative expenses are not covered by appropriations and are funded by operating revenues. For fiscal years 1996 and 1995, the MMI Fund incurred administrative costs of $342 million and $309 million, respectively.

Asset Sales

During fiscal year 1996, mortgage notes were sold for amounts with a present value of $265 million and $533 million net of expenses, for the MMI and GI/SRI Funds, respectively. In fiscal year 1995, the GI/SRI Funds generated a net of $399 million of additional cash flows from mortgage note sales. In 1996, Congress provided standing authorization to use the proceeds to help fund program operations. In 1995, in accordance with standard Credit Reform requirements, the proceeds were returned to Treasury.

Subsidy Re-estimates

Periodic subsidy re-estimates are required by Credit Reform to assure that the amount of monies necessary for credit subsidies is sufficient to cover estimated costs. Downward adjustments result from having received more subsidy than is believed needed, and the excess is deposited to a special receipt account at the Treasury. Upward adjustments result in additional monies due, which are financed by standing legislation and do not require additional Congressional action, although approval to receive and utilize the monies must be made by the Office of Management and Budget.

The following subsidy re-estimates were made during fiscal years 1996 and 1995 to bring the subsidy amount to that necessary to cover estimated costs (dollars in millions):

Fund	1996	1995
MMI	Upward, $181	Downward, $1,200
GI/SRI	Downward, $110	N/A

There were no subsidy re-estimates made for GI/SRI during fiscal year 1995.

Borrowings From the U.S. Treasury

In fiscal year 1996, the MMI and GI/SRI Funds borrowed $1.6 billion from the U.S. Treasury to primarily cover net cash inflows from the termination of the assignment program and subsidy re-estimates.

The changes in the borrowings from the U.S. Treasury are summarized below (dollars in millions):

	MMI	GI/SRI	Total
Balance, September 30, 1994	$ 286	$ 497	$ 783
Borrowings	885	0	885
Repayments	0	(21)	(21)
Balance, September 30, 1995	$1,171	$ 476	$1,647
Borrowings	1,530	86	1,616
Repayments	0	(140)	(140)
Balance, September 30, 1996	$2,701	$ 422	$3,123

All funds borrowed from the U.S. Treasury may be repaid in whole or in part prior to loan maturity without penalty. The balance of borrowings from the U.S. Treasury at September 30, 1996 and 1995, have maturity dates and interest rates as summarized below (dollars in millions):

Fund	1996	1995	Interest Rate	Year of Maturity
MMI:				
	$ 286	$ 286	6.21%	2000
	205	0	6.33%	2003
	3	0	6.33%-7.11%	2004
	885	885	6.65%-6.77%	2014
	1,322	0	6.65%-7.59%	2015
Subtotal	$2,701	$1,171		
GI/SRI:				
	$ 336	$ 476	6.21%	2000
	61	0	6.33%	2003
	25	0	7.59%	2015
Subtotal	$ 422	$ 476		
Grand Total	$3,123	$1,647		

Note 11. Insurance in Force/Off Balance Sheet Risk

Insurance in force, which constitutes off balance sheet risk, is the original insured balance of all cases still in force, less principal payments made on the mortgages to date. Insurance in force outstanding as of September 30, 1996, was as follows (dollars in millions):

Fund	Single Family	Multifamily	Title I	Total
MMI	$337,449	$ 0	$ 0	$337,449
CMHI	0	271	0	271
GI	30,526	42.277	5,950	78,753
SRI	2,361	7,199	0	9,560
Total	$370,336	$49,747	$5,950	$426,033

Insurance in force outstanding as of September 30, 1995 was as follows (dollars in millions):

Fund	Single Family	Multifamily	Title I	Total
MMI	$317,869	$ 0	$ 0	$317,869
CMHI	0	298	0	298
GI	27,897	40,048	6,754	74,699
SRI	2,734	7,377	0	10,111
Total	$348,500	$47,723	$6,754	$402,977

Insurance written during 1996 and 1995 was as follows (dollars in millions):

Fund	1996	1995
MMI	$59,296	$42,812
GI	11,985	9,183
SRI	192	575
Total	$71,473	$52,570

FHA's insurance covers losses that result when borrowers default on their mortgage payments. FHA mortgage insurance covers only default risk, and thus FHA is not exposed to losses resulting from interest rate fluctuations, except in the case of mortgages insured pursuant to Section 221(g)(4) of the National Housing Act, as discussed in Note 12. In more cases, FHA insures 100% of the mortgage principal. However, when FHA pays claims resulting from mortgage defaults, a portion of the claim can normally be recovered through foreclosure and subsequent sale of the mortgaged property. In recent years, FHA has also recovered a portion of claims paid through public sale of the mortgage notes as discussed in Note 5.

The MMI Fund provides mortgage insurance principally for 30-year fixed rate home mortgages. By law, the MMI Fund must be operated in accordance with "sound actuarial and accounting practice". Borrowers should be charged a premium that will cover default losses and administrative expenses, and provide equity. Like all FHA activities, the MMI Fund suffers losses when premium income is insufficient to cover default losses and administrative costs. The magnitude of these losses is greater when there is either an increase in the number of mortgage defaults or a decrease in amounts recovered from the sale of foreclosed properties or mortgage notes sold. Since the MMI fund primarily insures low down payment mortgages, it is more susceptible to losses resulting from economic downturns. Such downturns may increase the number of defaults and result in lower claim recoveries when foreclosed properties are sold. Either situation could result in the MI Fund experiencing greater losses than have been provided for in the accompanying consolidated financial statements.

The GI Fund provides mortgage insurance for loans involving cooperative, condominiums, nursing homes, and hospitals; and for low and moderate income multifamily loans involving construction, rehabilitation, and refinancing. While the GI Fund's insurance in force is much less than that of the MMI Fund, its exposure to loss may be much greater. Unlike the MMI Fund, the GI Fund has no statutory requirement to be sound. In carrying out is mission, the GI Fund assumes levels of default risk not generally borne by commercial insurers or lenders. Furthermore, the GI Fund is susceptible to losses resulting from weaknesses in commercial and residential real estate markets at both the regional and national levels. Aggregate premiums charged by the GI Fund have not been sufficient to cover default losses and administrative costs. As a result, the GI Fund is dependent on appropriations to sustain its operations.

Activity for FHA's other two funds, SRI and CMHI, has been minimal in recent years. Since these funds have very little activity, FHA's exposure to additional loss from these funds is comparatively small.

The significant concentrations of FHA's multifamily insurance risk by program and the percent that the program is to the total multifamily insurance in force (IIF), are as follows (dollars in billions):

Program	IIF	Percent
Section 221(d)(4) – Market Rate	$17.2	34.6%
Section 207 – Rental Housing	7.5	15.2%
Section 242 – Hospital	5.0	10.0%
Section 232 – Nursing Homes	4.9	9.9%
Section 236 – Interest Subsidy	4.9	9.9%

The concentration of risk is geographically dispersed for both single family and multifamily, except for the Hospital Program. The insurance in force for the Hospital Program is located primarily in the northeast, with 91% of the $5 billion unpaid principal balance of the insurance in force attributed to the New York/New Jersey HUD Regions. New York state constitutes over 87% of the insurance in force for hospitals. The highest geographic concentration of risk for the remaining multifamily programs is in New York (13%), California (9%), Maryland (6%), Illinois (5%) and Ohio (5%). No other state comprises more than 5% of the unpaid multifamily insurance principal balance.

Note 12. Commitments and Contingencies

Section 221(g)(4) Program

Prior to the passage of the National Affordable Housing Act of 1990 (the Affordable Housing Act), single family and multifamily mortgages insured under Section 221 of the National Housing Act that were neither delinquent nor in default could be assigned to FHA pursuant to Section 221(g)(4) by lenders in exchange for FHA debentures bearing current interest rates. Eligible mortgagees could elect to assign their current mortgages to FHA during the year following the 20th anniversary after final endorsement of the mortgage. The assignment of these mortgages resulted in an additional costs to FHA to the extent that U.S. Treasury debenture rates exceeded the mortgage interest rates.

However, under the Affordable Housing Act, FHA was required to arrange for the sale of the beneficial interest in the multifamily mortgages in lieu of accepting assignment after the 20th anniversary. The sales price to be paid to the lenders was to be equal to the outstanding principal balance at the time of the sale plus accrued interest. To ensure this price was realized, FHA was required to make subsidy interest payments. The Affordable Housing Act, as amended, only provided for the auction of multifamily mortgages assigned through September 30, 1996.

Proposed legislation is in process to extend the auction authority through December 31, 2005, the natural sunset of the assignment program based on the November 30, 1983, Congressionally mandated termination date. It is unclear if, and when, this legislation will be approved.

However, until an approval is received, FHA will issue debentures to those eligible Section 221(g)(4) mortgagees. FHA management estimates that a maximum of 4,004 mortgages with an unpaid principle balance of $8.8 billion would be assigned through 2005.

Termination of the Single Family Assignment Program

Historically, FHA has taken assignment of a significant number of insured single family mortgage notes which are in default rather than settle the claims through foreclosure or other alternatives to foreclosure. Legislation was enacted in April 1996 to eliminate the single family mortgage note assignment program. It authorized FHA to implement new loss mitigation tools and expand existing alternatives to foreclosure. The accompanying consolidated financial statements do not include any adjustments that might result from this change.

Section 8 Subsidies

At the end of 1996, FHA estimates that roughly 8,600 projects (with an insured mortgage value of $17.6 billion) were receiving rental subsidies from a variety of non-FHA Section 8 subsidy programs.

As part of the 1997 Budget, Section 8 contract terms were limited to one year and changes were made to limit the level of rental subsidies paid under new Section 8 contract renewals and amendments. Various proposals to further reduce future subsidy payments made directly to project owners either have been advanced as part of the formal fiscal year 1998 budget process and related legislative submissions to Congress or are expected as part of the Congressional debate about the future of public and subsidized housing in the country.

Under proposals made by FHA, future rental subsidy rates would be changed so that rents paid by the government and/or low-income tenants would generally not exceed market rentals in the respective areas.

If FHA's or similar proposals were adopted, it is anticipated that multifamily insurance claims from subsidized projects would increase despite efforts to reduce the short-term losses to FHA, including debt and operational restructuring. While the amount of claims resulting from these proposals might be higher than in their absence, the long-term costs to FHA are projected to be lower.

The impact of these proposals would vary from project to project depending on such factors as current financial and physical condition, size and timing of subsidy changes, and local market conditions.

In addition, final costs to FHA of these additional claims would depend upon the methods used to restructure project mortgages or to minimize the actual transfer of the mortgages or properties to FHA ownership, and the methods used to dispose of any mortgages or properties assumed in a timely fashion.

The claims which would result almost all relate to insurance issued prior to 1991. FHA has available a permanent indefinite appropriation to pay these claims.

FHA estimates that approximately $6.2 billion of loss reserves on subsidized projects have already been accrued, for financial reporting purposes but not for budget purposes, as part of its estimation of potential losses on the entire insured portfolio at September 30, 1996. These reserves include the estimated overall financial impacts on FHA of possible changes to the present rent subsidy structure. Management believes these reserves adequately provide for estimated losses on subsidized projects.

Potential Organizational Changes

The accompanying consolidated financial statements have been prepared based on FHA's present statutory and organizational structure. However, significant changes to FHA's programs and legal structure are under consideration which, if enacted, might significantly affect FHA's mission and the way it conducts its operations. It is uncertain what changes will ultimately emerge and what impact, if any, they might have on FHA's financial position and results of operations. Accordingly, the accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of these legal actions and claims will not materially affect FHA's consolidated financial position or results of operations as of, and for, the fiscal year ended September 30, 1996.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING SCHEDULES—STATEMENTS OF FINANCIAL POSITION INFORMATION
SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	MMI		CMHI		GI		SRI		CONSOLIDATED	
	1996	**1995**	**1996**	**1995**	**1996**	**1995**	**1996**	**1995**	**1996**	**1995**
ASSETS:										
Fund Balances at the U.S. Treasury:										
Non-Interest Bearing	$ 2,888	$ 309	$ 6	$ 5	$ 2,230	$ 932	$ 484	$ 395	$ 5,608	$ 1,651
Interest Bearing	975	913	0	0	554	298	13	10	1,542	1,221
Total Fund Balances at the U.S. Treasury	3,863	1,232	6	5	2,784	1,230	497	405	7,150	2,872
Investments in U.S. Government Securities	7,642	6,586	19	19	0	0	0	0	7,661	6,605
Foreclosed Property Held for Sale, Net	929	1,001	0	0	203	211	10	8	1,162	1,200
Mortgage Notes Held for Sale, Net	2,344	3,317	1	0	1,573	2,683	53	107	3,971	6,107
Other Assets and Receivables	332	319	0	0	204	165	41	60	577	544
Total Assets	15,130	12,455	26	24	4,764	4,289	601	580	20,521	17,348
LIABILITIES AND GOVERNMENT EQUITY (DEFICIENCY)										
Claims Payable	532	331	0	0	115	105	17	7	664	443
Loss Reserves	2,235	2,169	6	6	9,426	7,800	1,319	1,090	12,986	11,065
Unearned Premiums	6,788	6,549	1	1	125	118	17	17	6,931	6,685
Debentures Issues to Claimants	0	0	0	0	80	87	2	0	82	87
Accounts Payable, Accrued Expenses, and Other Liabilities	194	200	0	0	179	290	51	54	424	544
Borrowings from the U.S. Treasury	2,701	1,171	0	0	422	476	0	0	3,123	1,647
Distributive Shares and Premium Refunds Payable	153	162	1	0	0	0	0	0	154	162
Elimination of Interfund Balances	0	0	0	0	(20)	(20)	20	20	0	0
Total Liabilities	12,603	10,582	8	7	10,327	8,856	1,426	1,188	24,364	20,633
Government Equity (Deficiency):										
Mutual Funds Equity	2,508	1,854	18	17	0	0	0	0	2,526	1,871
Subsidized Funds Cumulative Losses	0	0	0	0	(16,095)	(15,038)	(4,948)	(4,731)	(21,043)	(19,769)
Appropriated Capital	19	19	0	0	10,532	10,471	4,123	4,123	14,674	14,613
Total Government Equity (Deficiency)	2,527	1,873	18	17	(5,563)	(4,567)	(825)	(608)	(3,843)	(3,285)
Total Liabilities and Government Equity (Deficiency)	$ 15,130	$ 12,455	$ 26	$ 24	$ 4,764	$ 4,289	$ 601	$ 580	$ 20,521	$ 17,348

See Accompanying Independent Auditor's Report

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING SCHEDULES—STATEMENTS OF OPERATIONS INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	MMI		CMHI		GI		SRI		CONSOLIDATED	
	1996	1995	1996	1995	1996	1995	1996	1995	1996	1995
REVENUES:										
Premiums:										
Annual Premiums	$ 938	$ 778	$ 0	$ 2	$ 135	$ 120	$ 11	$ 14	$ 1,084	$ 912
Earned Portion of Up-front Premiums	768	911	1	0	254	241	35	35	1,058	1,189
Total Premiums Earned	1,706	1,689	1	2	389	361	46	49	2,142	2,101
Interest Income	812	677	1	1	115	186	50	43	978	907
Other Revenues	27	51	0	0	42	89	1	2	70	142
Total Revenues	2,545	2,417	2	3	546	636	97	94	3,190	3,150
EXPENSES:										
Change in Loss Reserves	66	(79)	0	0	1,626	(661)	229	(445)	1,921	(1,185)
Provision for Losses on properties Held for Sale	1,431	1,301	0	0	478	402	66	72	1,975	1,775
Provision for Losses on Mortgage Notes Held for Sale	(166)	288	0	0	(673)	(876)	20	453	(819)	(135)
Gain on Sale of mortgage notes Held for Sale	(72)	0	0	0	(113)	(531)	(2)	0	(187)	(531)
Salary and Administrative Expenses	429	391	0	0	252	248	2	5	683	644
Interest Expense	167	77	0	0	49	45	0	0	216	122
Other Expense	36	43	0	0	(16)	28	(1)	(1)	19	70
Total Expenses	1,891	2,021	0	0	1,603	(1,345)	314	84	3,908	760
(Deficiency) Excess of Revenues over Expenses	654	396	2	3	(1,057)	1,981	(217)	10	(618)	2,390
Government Equity (Deficiency), Beginning of Year	1,873	1,477	17	16	(4,567)	(6,403)	(608)	(618)	(3,285)	(5,528)
Distributive Shares Canceled	0	0	1	1	0	0	0	0	1	1
Distributive Shares Paid	0	0	(2)	(3)	0	0	0	0	(2)	(3)
Appropriations, Net	0	0	0	0	61	(145)	0	0	61	(145)
Government Equity (Deficiency), End of Year	$ 2,527	$ 1,873	$ 18	$ 17	$(5,563)	$(4,567)	$ (825)	$ (608)	$(3,843)	$(3,285)

See Accompanying Independent Auditor's Report

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING SCHEDULES—STATEMENTS OF GOVERNMENT EQUITY (DEFICIENCY) INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	Mutual Funds Equity			Subsidized Funds Cumulative Losses			Appropriated Capital				Equity Total
	MMI	CMHI	TOTAL	GI	SRI	TOTAL	MMI	GI	SRI	TOTAL	
Balance, September 30, 1994	$ 1,458	$ 16	$ 1,474	$(17,019)	$ (4,741)	$(21,760)	$ 19	$ 10,616	$ 4,123	$14,758	$ (5,528)
Excess of Reviews over Expenses	396	3	399	1,981	10	1,991	0	0	0	0	2,390
Distributive Shares Declared	0	(3)	(3)	0	0	0	0	0	0	0	(3)
Distributive Shares Canceled	0	1	1	0	0	0	0	0	0	0	1
Credit Appropriations Received to Finance:											
Credit Subsidies on 1995 Mortgages	0	0	0	0	0	0	0	0	0	188	188
Administrative Expenses	0	0	0	0	0	0	0	0	0	198	198
Appropriations Returned to Treasury:											
Negative Subsidy:											
On insured 1995 mortgages	0	0	0	0	0	0	0	0	0	(132)	(132)
As a result of modifications due to asset sales	0	0	0	0	0	0	0	0	0	(399)	(399)
Balance, September 30, 1995	$ 1,854	$ 17	$ 1,871	$(15,038)	$ (4,731)	$(19,769)	$ 19	$ 10,471	$ 4,123	$ 14,613	$ (3,285)
(Deficiency) Excess of Reviews over Expenses	654	2	656	(1,057)	(217)	(1,274)	0	0	0	0	(618)
Distributive Shares Declared	0	(2)	(2)	0	0	0	0	0	0	0	(2)
Distributive Shares Canceled	0	1	1	0	0	0	0	0	0	0	1
Credit Appropriations Received to Finance:											
Credit Subsidies on 1996 Mortgages	0	0	0	0	0	0	0	152	0	152	152
Credit Subsidies as a Result of Asset Sales	0	0	0	0	0	0	0	533	0	533	533
Administrative Expenses	0	0	0	0	0	0	0	202	0	202	202
Appropriations Returned to Treasury:											
Negative Subsidy:											
On insured 1996 mortgages	0	0	0	0	0	0	0	(142)	0	(142)	(142)
As a result of re-estimates	0	0	0	0	0	0	0	(110)	0	(110)	(110)
As a result of modifications	0	0	0	0	0	0	0	(40)	0	(40)	(40)
As a result of modifications due to asset sales	0	0	0	0	0	0	0	(53)	0	(533)	(533)
As a result of budget recessions	0	0	0	0	0	0	0	(1)	0	(1)	(1)
Government Equity (Deficiency), End of Year	$ 2,508	$ 18	$ 2,526	$(16,095)	$ (4,948)	$(21,043)	$ 19	$ 10,532	$ 4,123	$ 14,674	$ (3,843)

See Accompanying Independent Auditor's Report

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING SCHEDULES—STATEMENTS OF CASH FLOWS INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 1996 AND 1995
(Dollars in Millions)

	MMI		CMHI		GI		SRI		CONSOLIDATED	
	1996	1995	1996	1995	1996	1995	1996	1995	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES:										
(Deficiency) Excess of Reviews over Expenses	$ 654	$ 396	$ 2	$ 3	$ (1,057)	$ 1,981	$ (217)	$ 10	$ (618)	$ 2,390
Adjustments to Reconcile (Deficiency) Excess of Revenues to Net Cash										
Provided (Used) by Operating Activities:										
Provision for Losses on Properties and Mortgage Notes Held for Sale	1,265	1,589	0	0	(195)	(474)	86	525	1,156	1,640
Amortization of U.S. Government Securities	(57)	(39)	0	0	0	0	8	0	(57)	(39)
Gain on Sale of Mortgage Notes	(72)	0	0	0	(113)	(531)	(2)	0	(187)	(531)
Change in Assess and Liabilities:										
Claims Settlement payments	(4,527)	(4,354)	(1)	0	(920)	(1,142)	(94)	(67)	(5,542)	(5,563)
Collections of Principal on Notes Acquired in Claims Settlement	125	134	0	0	96	151	11	17	232	302
Proceeds from Disposition of Assess Acquired in Claims Settlement	4,233	2,633	0	0	2,250	1,677	51	39	6,534	4,348
(Increase) Decrease in Other Assets	(13)	(45)	0	0	(39)	18	19	(11)	(33)	(38)
Increase (Decrease) in Claims Payable and Other Liabilities	186	(59)	1	0	(101)	(63)	7	(1)	93	(123)
Increase (Decrease) in Loss Reserves	66	(79)	0	0	1,626	(861)	229	(445)	1,921	(1,185)
Up-front Premiums Collected	1,417	915	1	2	269	(251)	35	35	1,722	1,203
Up-front Premiums Earned	(768)	(910)	(1)	(2)	(254)	(241)	(35)	(35)	(1,058)	(1,188)
Up-front Premiums Refunded	(410)	(230)	0	0	(8)	(7)	0	0	(418)	(237)
Net Cash Provided (Used) by Operating Activities	2,099	(49)	2	3	1,554	959	90	66	3,745	979
CASH FLOWS FROM INVESTING ACTIVITIES:										
Purchase of U.S. Government Securities	(7,655)	(6,732)	0	(5)	0	0	0	0	(7,655)	(6,787)
Maturity of U.S. Government Securities	6,657	5,901	0	2	0	0	0	0	6,657	5,903
Net Cash Used by Investing Activities	(998)	(881)	0	(3)	0	0	0	0	(998)	(884)
CASH FLOWS FROM FINANCING ACTIVITIES:										
Borrowings from U.S. Treasury	1,530	885	0	0	86	0	0	0	1,616	885
Repayment of Borrowings from U.S. Treasury	0	0	0	0	(140)	(21)	0	0	(140)	(21)
Appropriated Capital	0	0	0	0	887	386	0	0	887	386
Return of Appropriated Capital	0	0	0	0	(826)	(531)	0	0	(826)	(531)
Issuance of Debentures to Claimants	0	0	0	0	63	41	2	0	65	41
Payment of Debentures to Claimants	0	0	0	0	(70)	(66)	0	0	(70)	(66)
Participant Distributive Shares Canceled	0	0	1	1	0	0	0	0	1	1
Participant Distributive Shares Declared	0	0	(2)	(3)	0	0	0	0	(2)	(3)
Net Cash Provided (Used) by Financing Activities	1,530	885	(1)	(2)	(0)	(191)	2	0	1,531	692
Net Increase (Decrease) in Cash and Cash Equivalents	2,631	(45)	1	(2)	1,554	768	92	66	4,278	787
Cash and Cash Equivalents, Beginning of Year	1,232	1,277	5	7	1,230	462	405	339	2,872	2,085
Cash and Cash Equivalents, End of Year	$ 3,863	$ 1,232	$ 6	$ 5	$ 2,784	$ 1,230	$ 497	$ 405	$ 7,150	$ 2,872

See Accompanying Independent Auditor’s Report

March 5, 1996

MEMORANDUM FOR: James A. Heist, Director, Financial Audits Division, GAF

FROM: Kathryn M. Rock, Housing-Federal Housing Administration Comptroller, HF

SUBJECT: Comments on the Draft "Independent Auditors Report" for Fiscal Year 1996

This memorandum contains FHA management's comments pertaining to the FHA Fiscal Year 1996 independent auditor's report. It is intended to provide FHA's comments on auditor positions of FHA operations which we would like taken into consideration in preparing your final report.

On page nine of Appendix A, the auditors note that "…implementing sufficient change to mitigate the internal control weaknesses is a multiyear task due to the complexity of issues and impediments to change that FHA and HUD face." The paragraph goes on to note that many of these impediments are driven by outside forces, however, "FHA must continue to address its own self imposed impediments to achieving necessary change."

FHA agrees with this assessment, and would like to note that many actions are already underway to delegate authority, increase accountability, establish performance based measures, and reengineer business processes to achieve greater customer focus, efficiency and control. Examples include delegating waiver authority to field management, establishing specific field outcome measures through the annual management plan, and completion of staff driven business process redesign efforts. These and other similar initiatives will continue and are key priorities for FHA senior management.

Additional comments follow.

Page nine states that "budget restrictions lead to...staff reductions." The staff reductions are not budget driven but rather are a part of the Government's downsizing effort begun several years ago.

FHA has begun using specialized asset managers. Page 11 speaks of this as yet to happen.

The second bullet on page 33 should recognize that reflector sales for 221(g) (4) mortgages is one tool, and that there are other disposition tools, such as auction authority, that will be evaluated to determine the best disposition strategy.

Page 43 addresses noncompliance with the Credit Reform Act. The reason given is that single family premium "data is allocated to cohorts and risk categories using some estimates of cash flows (rather than actual cash flows)...." There is a fine yet important distinction to be made. Regarding these single family premiums the correct total amount of cash flow is known.

It is the allocation to the proper cohort of these actual cash flows which is estimated. A cold reader may misunderstand the sentence to mean that FHA estimates its cash flows.

We appreciate the opportunity to offer our comments to your draft and also appreciate the efforts of your staff and the independent auditors to help us improve FHA operations.

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